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ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

FEBRUARY 18, 19, 22, 23, 24; MARCH 30, 31; APRIL 1, 2, 5, 6; AND MAY 5, 1982

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ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

TUESDAY, MARCH 30, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 11:05 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. The committee will come to order. I want to welcome all of our guests and witnesses to the committee hearing.

This is a continuation of the testimony that the committee has been taking on the administration's revenue-raising proposals. This morning, the Chair wants to make the observation that I expect to work through the lunch period. I hope that those witnesses who expect to testify at 2 p.m. will have their lunch a little earlier so that we can work through the lunch period.

The Chair also wants to make the observation that the witnesses have been given allocated times. However, if your testimony runs longer than the time that we have allocated, we suggest that you summarize with the assurance that your entire statement will be included in the record. This will then enable us to engage in dialog with the witnesses.

We want to welcome to Washington all of the people in the housing industry who are present at today's hearing. If you want to get something done, you are in the right place. We hope that you let your Members know what your position is with respect to the economic recession.

I want to welcome Mr. Oswald, Mr. Rahn, Mr. Huard, and Mr. Laguarta. We will begin with the testimony of Mr. Laguarta. You may proceed.

STATEMENT OF JULIO LAGUARTA, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, ACCOMPANIED BY JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST

Mr. LAGUARTA. Thank you, Mr. Chairman. I am Julio Laguarta, president of the National Association of Realtors. I am accompanied today by Dr. Jack Carlson, our chief economist and executive vice president of NAR.

On behalf of the nearly 700,000 members of the National Association we greatly appreciate the opportunity to present our views on

the impact of Federal budget policies on the overall economy and housing.

The overall economy has declined in the fourth quarter of 1981 at an annualized rate of 4.7 percent and unemployment approached 9 percent, and that decline is continuing in this quarter. Moreover, the economy has been sick for nearly 3 years. The hardest hit sector has been shelter, which accounts for over one-third of the Nation's GNP.

Housing activity has declined for 40 months and this decline has accelerated during the past 12 months. We are in the worst housing depression since the 1930's. Existing and new home sales and starts have fallen by more than 50 percent from peak to trough.

More Americans have lost the opportunity to satisfy their homeownership need than at any other time in our history. About 5 million households have been denied the opportunity to buy adequate housing of their own, of which nearly 3.5 million would have been purchases of existing homes.

The Federal Government is the primary cause of the housing depression and has impacted housing primarily through record deficits, record borrowing by the Federal Government to fund deficits, and record taking-away of personal and other savings from use by housing and industry.

These have resulted in the following things: They have created record real interest rates, double and triple the normal 3-percent level during the postwar period to an average of 6.9 percent during 1981, 11.5 percent so far in 1982, and 8.2 percent in our forecast for 1983.

They have also caused a loss in the value of every American's home of up to 25 percent and caused a loss in the value of the average American's savings and investment in housing by 50 percent. It has also completely offset the stimulating effects of last year's tax incentives to invest.

It will limit the next economic recovery to about one-half the normal rate. Thus, it will provide only modest improvement in our Nation's standard of living and a limited increase in jobs during the next 3 years. It will continue to cripple the interest-sensitive sectors and the mature regions of the country, such as the Northeastern and North-central States.

It will lead to greater economic concentration and conglomerate tying arrangements which will likely cause higher housing costs and less homeowner choice in financing and products and other services.

Housing serves the Nation in three ways: One, as shelter for individuals and families and in the case of families to nurture the next generation; two, as incentives to save and to invest; and, three, as the best way Americans have devised to disperse real decisionmaking.

During the last 3 years the proportion of the gross national product for housing has declined from 6 percent to 3 percent. The proportion of loanable funds going to housing has declined from 45 percent to less than 25 percent. Housing supply failed to meet the underlying demand for housing during the 1979–81 period. There will be an even greater shortage of housing supply if policies do not change.

Therefore, we offer these recommendations. One, that Federal spending growth must be slowed down in all parts of the Federal budget, including defense, entitlement programs, and other programs. We firmly believe the 1983 total Federal deficit without urgent action by the Congress will exceed $150 billion.

We urge a total Federal deficit of less than $75 billion for 1983 and a balanced budget for 1985 or 1986. Spending this year has overrun the commitments of the President and the Congress by double the rate compared to past Presidents and Congresses during the last 10 years.

Two, tax relief planned for July 1983 and indexing schedule for 1985 should be deferred.

Three, other tax increases to discourage consumption, but not savings and investment, should be adopted to the extent spending changes are insufficient to meet the deficit goals. In 1981 realtors recommended individual tax relief be limited to 5 percent across-the-board each year instead of 10 percent, and that tax relief be no larger than spending reductions to achieve a balanced budget by 1984.

Four, because of the disasterous condition and the disproportionate share of the economic downturn endured by housing, there should be modification of existing programs to help more first-time homebuyers and revive housing and the entire economy.

We are proposing: (*a*) the administrative and legislative improvements in the State and municipal housing bond programs. These improvements will provide as much as $10 billion or more for mortgages, the equivalent of helping 300,000 to 400,000 families gain access to housing during this program. Incidentally, we understand you are going to conference on that program sometime this week; (*b*) we propose a tax credit for first-time homebuyers, enabling lowered monthly payments or downpayments, thus qualifying more families. Use of existing funds from those estimated for the all savers program, which you and we know has not worked and has not found its way into housing, could allow another 250,000 American families to own a home, and; (*c*) we are proposing a tax credit for the lender who would pass along the savings to the buyer. The use of existing funds from those estimated for the all savers certificates could allow an additional 250,000 families to own their own homes.

The mortgage bond amendments could be implemented in the upcoming House-Senate conference on H.R. 4717, the Miscellaneous Revenue Act of 1981. We strongly believe this is the most immediate way to provide some relief for housing. It would not add to budget deficits; it would be temporary, being sunsetted by the end of 1983; it would be limited to first-time homeowners, 90 percent of whom cannot now qualify for the medium-priced home in our country; and it would include new and existing homes. Existing homes stimulate as many jobs for Americans as are created by new homes.

In the long run, incentives must be provided for housing, such as IRA-type tax-free savings accounts for first-time homebuyers and tax credits for firms and people who invest in home mortgages.

With regard to the administration's tax proposals, the National Association of Realtors provides the following comments:

The alternative minimum tax: NAR supports the enactment of a reasonable alternative minimum tax rather than an add-on minimum tax. A reasonable alternative minimum tax will help insure that corporations as well as individuals will pay their fair share of taxes. We would welcome the opportunity to work with this committee in the development of suggested tax preference items for an alternative minimum tax.

Construction period interest and taxes: The proposal to force corporations to amortize over 10 years interest and taxes paid or incurred during the construction period of a nonresidential building should be rejected. Extending this rule beyond individuals and partnerships to corporations would only extend the real estate discrimination already in the tax law. We would urge instead that current expensing of construction period interest and taxes should be allowed for both individuals and corporations.

Withholding on interest and dividends; Rather than impose a withholding tax on interest and dividends, we support the concept of increased information reporting on this type of income. Withholding is not needed. It is impractical. It is burdensome and would provide minimal revenue increases, if any, after offsetting for additional costs of withholding.

Adoption and implementation of the recommendations we make today would help return the entire economy to health by helping housing lead the way, as it has always done.

I might add, gentlemen, we have an ad in today's Washington Post, a copy of which we have for you, and it is included in our testimony. It characterizes housing pulling Uncle Sam out of the current recession.

Mr. Chairman, that concludes our testimony.

[The prepared statement follows:]

Statement on Behalf of the National Association of Realtors by Julio S. Laguarta and Jack Carlson

I am Julio S. Laguarta, President of the NATIONAL ASSOCIATION OF REALTORS® and I am accompanied by Dr. Jack Carlson, Chief Economist and Executive Vice President of the Association.

On behalf of the nearly 700,000 members of the National Association, we greatly appreciate the opportunity to present our views on the impact of federal tax and budget policies on the overall economy and housing.

The overall economy has declined in the fourth quarter of 1981 at an annualized rate of 4.7 percent and unemployment approached 9 percent, and that decline is continuing in this quarter. Moreover, the economy has been sick for nearly 3 years. The hardest hit sector has been shelter which accounts for over one-third of the Gross National Product.

Housing activity has declined for forty months and this decline has accelerated during the last 12 months. We are in the worst housing depression since the 1930s. Existing and new home sales and starts have fallen by more than 50 percent from peak to trough in dramatic and stark contrast to the overall national economy. More Americans have lost the opportunity to satisfy their homeownership need than at any other time in the United

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States' history (Attachments 1 and 2). About 5 million households have been denied the opportunity to buy adequate housing of their own, of which nearly 3-1/2 million would have been purchases of existing homes.

The Federal government is the primary cause of the housing depression and has impacted housing primarily through:

(1) Record deficits (Attachments 3 and 4).

(2) Record borrowing by the Federal government to fund deficits.

(3) Record taking away of personal and other savings from use by housing and industry.

These events:

(4) Have resulted in record real interest rates, double and triple normal levels which have increased from the normal 3 percent level during the post-war period to an average of 6.9 percent during 1981; 11.5 percent so far in 1982; and 8.2 percent in our forecast for 1983 (Attachment 5).

(5) Have caused a loss in the value of every American's home up to 25% and caused a loss in the value of the average American's savings and investment in housing by 50% (Attachments 6 and 7).

(6) Will completely offset the stimulating effects of last year's tax incentives to invest (Attachment 8).

(7) Will limit the next economic recovery to about one-half the normal rate (Attachment 9), and

(8) Thus, will provide only modest improvement in our nation's standard of living and a limited increase in jobs during the next three years (Attachment 10).

(9) Will continue to cripple the interest-sensitive sectors and the mature regions of the country, such as the North Eastern and North Central States.

(10) Will lead to greater economic concentration and conglomerate tying arrangements which will likely cause higher housing costs and less homeowner choice in financing and products and other services.

Housing serves the nation in three ways: (1) as shelter for individuals and families and in the case of families to nurture the next generation; (2) as incentives to save and to invest; and (3) as the best way Americans have devised to disperse real decision-making.

During the last three years the proportion of the Gross National Product for housing has declined from 6 percent to 3 percent (Attachment 11). The proportion of loanable funds going to housing has declined from 45 percent to less than 25 percent (Attachment 12). Housing supply failed to meet the underlying demand for housing during 1979-81, and is forecast to create an even greater shortage if policies do not change.

RECOMMENDATIONS

The NATIONAL ASSOCIATION OF REALTORS® strongly recommends:

(1) Federal spending growth must be slowed down in all parts of the federal budget, including defense, entitlement programs, and other programs. We firmly believe the 1983 total federal deficit without urgent action by the Congress will

exceed $150 billion (Attachment 3). We urge a total federal deficit of less than $75 billion for 1983 and a balanced budget by 1985 or 1986. Spending this year has overrun the commitments of the President and the Congress by double the rate compared to past Presidents and Congress' during the last 10 years (Attachment 13).

(2) Tax relief planned for July 1983 and indexing scheduled for 1985 should be deferred.

(3) Other tax increases to discourage consumption, but not savings and investment, should be adopted to the extent spending changes are insufficient to meet the deficit goal. In 1981 REALTORS® recommended individual tax relief be limited to 5 percent across-the-board each year, instead of 10 percent, and that tax relief be no larger than spending reductions to achieve a balanced budget by 1984 (Attachments 14 and 15).

(4) Because of the disastrous condition of, and disproportionate share of the economic downturn endured by housing, there should be modification of existing programs to help more first-time homebuyers and help revive housing and the entire economy (Attachment 16 for greater detail).

a. Administrative and legislative improvements in the state and municipal housing bond program [1/] should provide as much as another $10 billion for more mortgages, equivalent to helping 300,000 to 400,000 families, and

b. A tax credit for first-time homebuyers enabling lowered monthly payments or downpayment, thus qualifying more

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1/ The President's proposals on this and other housing actions are itemized in Attachment 19.

families. Use of existing funds from those estimated for the All Savers Certificate could allow 250,000 more families to own their homes, or

c. A tax credit for the lender who would pass along the savings to the buyer. The use of existing funds from those estimated for the All Savers Certificate could allow an additional 250,000 families to own their own homes.

The mortgage bond amendments could be implemented in the upcoming House-Senate Conference on H.R. 4717, the Miscellaneous Revenue Act of 1981. We strongly believe this is the most immediate way to provide some relief for housing. The program would:

a. Not add to deficit estimates.

b. Be temporary by being sunsetted in 1983.

c. Be limited to first-time homeowners (90 percent of whom cannot now qualify for the medium-priced home).

d. Include new and existing homes. Existing home sales stimulate as many jobs for Americans as are created by new homes.

(5) For the long run, incentives must be provided for housing -- such as an IRA-type tax-free savings account for first-time homebuyers and tax credits for firms and people who invest in home mortgages.

With regard to the Administration's tax proposals, the NATIONAL ASSOCIATION OF REALTORS® provides the following comments:

(6) Alternative Minimum Tax -- the National Association supports the enactment of a reasonable alternative minimum tax rather than an add-on minimum tax. A reasonable alternative minimum tax will help ensure that corporations as well as individuals will pay their fair share of taxes. We would welcome the opportunity to work with this Committee in the development of suggested tax preference items for an alternative minimum tax.

(7) Construction Period Interest and Taxes -- the proposal to force corporations to amortize over 10 years interest and taxes paid or incurred during the construction period of a non-residential building should be rejected. Extending this rule beyond individuals and partnerships to corporations would only extend the real estate discrimination already in the tax law. We would urge instead that current expensing of construction period interest and taxes should be allowed for both individuals and corporations.

(8) Withholding on Interest and Dividends -- Rather than impose a withholding tax on interest and dividends, we support the concept of increased information reporting requirements on this type of income. Withholding is not needed, is impractical, burdensome and would provide minimal revenue increases, if any, after offsetting for additional costs of withholding.

Adoption and implementation of the recommendations we make today would help return the entire economy to health by helping housing lead the way as it has always done.

ATTACHMENTS

1. Periods of Decline in Existing Home Sales.
2. The American Dream of Homeownership.
3. Record Deficits.
4. Central Government Deficits in Major Industrial Countries.
5. Record Real Interest Rates.
6. Homeowners Loss in Value of Homes.
7. January 26, 1982 REALTORS® Advertisement
8. Tax Incentives to Invest Offset by Interest Rates.
9. Recovery Limited.
10. April 1982 Forecast Tables.
11. Housing as Share in Gross National Product (GNP).
12. Housing as Share of Loanable Funds.
13. Spending Overruns Beyond Presidents' Budgets.
14. REALTORS® 1981 Recommendations on Size of Tax Relief.
15. Letter of January 21, 1981, to Other Associations Suggesting They Find Cuts Too.
16. Housing Assistance
17. Impact of REALTORS® Recommendations:
    - o Fiscal Policy
    - o Mortgage Bonds Modifications
    - o Tax Credit for First-time Home Buyers.
    - o Combined Benefits
18. Joint Statement by Members of The Group

Attachment 1

PERIODS OF DECLINE IN EXISTING HOME SALES

Housing Recession	Duration of Sales Cycle (Peak to Recovery)	Percent Decline in Existing Home Sales (Peak to Trough)	Unit Volume of Sales Lost	Dollar Volume of Sales Lost (in Billions of Dollars)
Dec. 1968 to Mar. 1970	21 months	-19.9 percent	236,000	$ 5.7
Feb. 1973 to Jan. 1975	32 months	-18.4 percent	489,000	$ 17.4
Nov. 1978 to Feb. 1982 (So Far)	40 months (So Far)	-53.7 percent	3,352,000	$240.0

Source: NATIONAL ASSOCIATION OF REALTORS®

Attachment 2.1

THE AMERICAN DREAM OF HOMEOWNERSHIP

Policy Statement Adopted by the
Board of Directors
February 8, 1982

The NATIONAL ASSOCIATION OF REALTORS® is dedicated to providing and protecting the opportunity for all Americans to own their own home. Homeownership extends beyond decent and satisfactory shelter and creates the incentive to save and invest. Homeownership allows each individual to own a piece of America. The home encourages more active participation in the community which is fundamental to our democratic system.

But homeowners and homebuyers have suffered disproportionately during recent times. Record high interest rates have kept many Americans from selling homes, depressed the value of all homes and have denied many thousands of would-be homebuyers from realizing the American dream.

Workers are being discouraged from selling their current home to buy a home nearer a better job. Consequently, the nation's businesses are suffering lower productivity and workers are receiving lower wages or experiencing unemployment.

Existing and new home sales during the past three years have declined by more than 50 percent. The cause can be traced to bad government policies which have driven interest rates to record high levels after adjusting for inflation.

In support of homeownership and democracy, we petition the Federal government to bring mortgage interest rates down by:

- reducing the federal deficit and federal borrowing to allow lendable funds to be used for housing;

- allowing the money supply to grow two percentage points faster than planned by the Federal Reserve Board and stabilizing growth to eliminate unnecessary and harmful fluctuation of interest rates;

- providing more adequate incentives for investment in homeownership to match more generous incentives provided for other investment;

- allowing Individual Housing Accounts for first time homebuyers (pattered after Individual Retirement Accounts);

- providing a housing mortgage tax credit for investors to stimulate an increasingly larger proportion of home mortgages; and

• providing a tax credit as assistance to those who wish to own a home. The tax incentive could take a variety of forms, should be temporary, and should be structured to qualify the largest possible number of first time homebuyers for mortgage loans.

Short-term programs should be designed to merge smoothly into long-term programs. Any type of housing assistance should be matched with offsetting spending reductions or tax programs. These programs should not add to the Federal deficits, but reduce the deficit in 1984 and beyond, which has been the primary cause of high real interest rates.

Every American should have the opportunity for homeownership. Every American should have the opportunity for adequate shelter and the opportunity to save and invest in their own home. Just as important, every person should have the opportunity to participate in our democratic process by owning a piece of their country.

We recognize that government policy has caused high interest rates which threaten the viability of savings and loans and community banks, which have traditionally provided mortgages for housing. We recognize further that economic policies have not adequately encouraged savings and, in fact, have encouraged consumption.

The NATIONAL ASSOCIATION OF REALTORS® supports measures to encourage increased savings and the development of programs to insure a greater flow of funds into mortgages, including more mortgage lending by thrifts and community banks. The Adjustable Rate Mortgage, with homeowner safeguards against abrupt changes in monthly payments, will lower the risk of mortgage lending for those affected by the current housing crisis. We expect the fixed payment and fixed rate mortgage (fully amortized) will continue to be relied upon, particularly as stabilized interest rate conditions return. In the transition we would support assistance for the thrifts that can be viable in the long run with limited federal help.

The NATIONAL ASSOCIATION OF REALTORS®, in pursuit of its goal of affordable housing opportunities for the nation as a whole, is seriously concerned with recent public actions and proposals.

• We think it unwise to tolerate huge and growing federal deficits and federal borrowing that takes away a large proportion of people's savings and reduces investment in housing.

• We think it unwise to slow money and credit growth so severely that it continues the recession and undermines homeownership.

• We think it unwise to cause interest rates to fluctuate so widely that it raises unnecessary fears about the future.

• We think it is unwise to permit savings and loans, which were created to serve homeownership, to invest every deposit dollar outside home mortgages.

- We think it is unwise to encourage economic concentration and less competition by promoting vertical, horizontal and conglomerate mergers of financial entities which transfer control of savings and investment from communities to national and international financial and other organizations.

- We believe it unwise to encourage or permit savings and loan and banks to lend to their subsidiaries for businesses outside of banking, thereby undermining competition in other industries and compromising fiduciary responsibilities to depositors.

We urge all Americans and our government to keep alive the American dream of homeownership.

ATTACHMENT 3

THE FEDERAL TOTAL DEFICIT AND SAVINGS
($ Billions)

Fiscal Year	Surplus or Deficit(-)			
	Amount	Percent of GNP	Percent of Personal Savings	Percent of Private Savings
1948	12.0	4.9	173.3	35.9
1949	0.6	0.2	5.5	1.4
1950	-3.1	1.2	29.5	7.6
1951	6.1	2.0	51.8	13.9
1952	-1.5	0.4	8.7	2.7
1953	-6.5	1.8	35.9	11.5
1954	-1.2	0.3	6.5	2.1
1955	-3.0	0.8	19.0	4.9
1956	4.1	1.0	21.8	6.1
1957	3.2	0.7	14.2	4.4
1958	-3.0	0.7	13.5	4.1
1959	-12.9	2.7	54.0	16.0
1960	0.3	0.1	1.5	0.4
1961	-3.4	0.7	16.8	4.3
1962	-7.1	1.3	28.8	8.0
1963	-4.8	0.8	22.2	5.3
1964	-6.0	1.0	23.8	6.0
1965	-1.6	0.2	5.2	1.4
1966	-3.8	0.5	10.7	3.0
1967	-8.8	1.1	21.9	6.6
1968	-25.2	3.0	55.2	17.6
1969	3.2	0.4	8.6	2.3
1970	-2.8	0.3	5.8	1.9
1971	-23.0	2.2	37.5	13.5
1972	-23.4	2.1	43.4	12.8
1973	-14.9	1.2	23.3	7.2
1974	-6.1	0.4	7.1	2.6
1975	-53.2	3.6	58.6	21.0
1976	-73.7	4.5	82.0	24.9
1977	-53.6	2.9	74.0	17.3
1978	-59.2	2.8	76.1	17.0
1979	-40.2	1.7	47.6	10.2
1980	-73.8	2.9	76.0	17.4
1981	-78.9	2.8	78.9	17.1
1982 e	-118.3 (131.3) [145.5]	3.8 (4.3) [4.7]	90.3 (100.2) [111.0]	22.9 (25.4) [28.1]
1983 e	-107.2 (137.1) [164.0]	3.1 (4.0) [4.8]	65.4 (83.6) [100.0]	17.5 (22.3) [26.7]
1984 e	-97.2 (144.1) [162.7]	2.6 (3.8) [4.3]	48.5 (71.8) [81.1]	13.6 (20.2) [22.8]

Footnote 1: Figures in parenthesis are based on CBO budget estimates.
Footnote 2: Figures in [ ] are based on REALTORS® budget estimates.

SOURCE: Budget of the United States Government, 1983, Congressional Budget Office, An Analysis of the President's Budgetary Proposals For Fiscal Year 1983 Savings data from the national income accounts and estimates by the NATIONAL ASSOCIATION OF REALTORS®.

ATTACHMENT 4

CENTRAL GOVERNMENT DEFICITS IN
MAJOR INDUSTRIAL COUNTRIES

Country	FY1982 Deficit 1/ $US billions	FY1982 Deficit 1/ % of Personal Savings in 1982 2/	Real Long-Term Interest Rates
United States	118.3 (145.5) 3/	100.2 (111.0)	7-8
Japan	31.8	18.3	2-3
West Germany	23.2	37.8	3.0
France	11.6	19.0	3.0
United Kingdom	15.6	62.5	5

1/ Federal deficit for U.S., general government current account deficits for calendar 1982 for all other countries.

2/ 1982 personal savings figures for all countries other than the U.S. supplied by Wharton Econometric Forecasting Associates.

3/ Figures in parenthesis are REALTOR® estimates.

ATTACHMENT 5

REAL INTEREST RATES IN THE UNITED STATES

Period	Real Long-Term Interest Rates 1/
1950 - 1959 Average	2.04
1960 - 1969 Average	3.41
1970 - 1979 Average	2.23
1980	5.00
1981	6.91
1982 (Forecast)	8.90
1983 (Forecast)	8.20
1984 (Forecast)	8.20

1/ Real long-term interest rates are defined as mortgage rates minus the rate of inflation as measured by the percent change in the GNP deflator.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

ATTACHMENT 6

HOMEOWNERS LOSS IN VALUE OF HOUSING

Value to Seller		Buyer's Monthly Principal and Interest Payment
$72,100	Normal Conditions Mortgage rate 10% (3% real)	$506
$66,800	Current Market with "people-to-people" financing 13% (6% real)	$591
$55,400	Current Market with new mortgage interest rates provided by financial institutions 17% (10% real)	$631

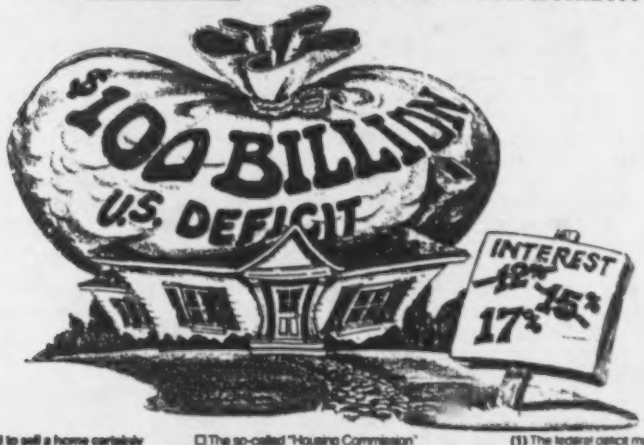
Everybody loses in the current market. Sellers are forced to sell at prices which have not kept up with inflation and sacrifice to provide "people-to-people" financing. Effective sales price is thus $16,700 below that received in normal circumstances.

The seller's loss does not turn out to be the purchaser's gain, however. A purchaser of a home for $55,400 at today's interest rates would have principal and interest payments of $631 -- $125 more than for the purchase of the home for $72,100 at 10 percent interest. The "people-to-people" financing price and interest rate minimize both the seller's loss and the buyer's payment jump.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

ATTACHMENT 7

HOMEOWNERS: FEDERAL DEFICIT AND CREDIT POLICIES ARE CAUSING HIGH INTEREST RATES—WHICH ARE TAKING UP TO ONE-FOURTH OF THE VALUE OF YOUR HOME...



...Anyone who has tried to sell a home certainly knows it. And anyone about to sell a home will soon find out. The value of the homes of a 150 million people is being crushed. The reason: The federal government is mismanaging the economy.

Record-high interest rates are the problem. Government policies are the cause. The government is causing record-high mortgage interest rates. During the past 40 years, mortgage interest rates have averaged about 3 percent above the underlying inflation rate, which currently is about 9 percent. So, interest rates for home mortgages should average 12 percent. However, they are 17 percent or higher.

When applied to a $90,000 home, the higher interest rate drives the market value down to $65,000. Thus, a typical family can feel the loss from its savings. Homebuyers lose too. Their monthly payments are no lower—and more than 3 million homebuyers are being driven out of the market each year.

The government is depressing the value of homes by $25,000 for the average homeowner. Home values are declining for two reasons:

First, our government is causing $100 billion deficits by spending beyond its means. These record deficits are financed by borrowing so much from people's savings that very little is left for housing. The scramble for the small remaining funds results in record-high interest rates.

Second, our government is squeezing down unnecessarily hard on the growth of credit, while at the same time taking a larger share of credit to feed deficit spending.

The government is hurting home ownership in other ways.

☐ Tax relief last year created incentives to divert funds away from home mortgages.

☐ The government proposes to close down the self-supporting FHA, VA and GNMA programs that are necessary for many families to buy homes.

☐ The government is focusing on ways to help savings and loan banks at the expense of home ownership.

☐ The so-called "Housing Commission" proposes that the federal government override state laws that limit increases in interest rates on mortgages assumed when homes are sold.

☐ The administration recommends allowing savings and loans to abandon home mortgages, even though they were created to serve home ownership.

☐ The administration recommends allowing community banks to be swallowed by huge financial corporations and give them unfair advantage over small businesses who do not have protective federal charters, federal insurance and access to government credit.

☐ The administration is pursuing a philosophy that "big business is beautiful" and "small business is ugly," an approach that is likely to lead to higher costs for home ownership.

Homeowner ingenuity is keeping the American dream alive. American resourcefulness alone is keeping the goal of home ownership alive for many people. Despite the government's discouraging economic policies, buyers and sellers are striking "creative financing" agreements that make home ownership possible.

When people sell and buy homes, for example, to move to jobs, sellers are helping buyers with the financing. Also, assumptions of existing mortgages are helping. People-to-people financing is making possible about two-thirds of all home sales by providing financing at 13 percent. The people who have access to this financing find that now is a good time to buy and sell. However, most other Americans have to face the 17 percent government-caused rates.

But homeowners can't go it alone forever. If the government were demonstrating the same resourcefulness as the American people, we would realize the American dream for millions more.

What can homeowners do? Homeowners must act now to make democracy work. They must change the policies that are crowding away their life savings. We must insist that the President, the Congress and the Federal Reserve Board act responsibly.

(1) The federal deficit must be reduced from the record $100 billion in 1982 toward $50 billion in 1983 and balance in 1984—by cutting the growth in spending to live within the government's means and, if necessary, by delaying tax relief in ways that will encourage savings and investment.

(2) The President, the Congress and the Federal Reserve Board must work to bring interest rates down—by allowing credit and money to grow 1 to 2 percentage points faster in 1982 than is planned by the Federal Reserve Board, and by reducing the fluctuation in interest rates.

The federal government must serve the credit needs of housing and industry and not just its own needs for credit.

Here's how to get your message to your congressmen. Fill out the coupon below and mail your message to us. We will see that your message gets to each of your U.S. senators and your representative. In addition, we will keep you informed of the progress on a monthly basis.

Clip the coupon below and mail it to:

NATIONAL ASSOCIATION OF REALTORS®
F Street Station, P.O. Box 50315, Washington, D.C. 20004

Dear Senators and Representatives:

I am angry about the loss of one-fourth of the value of my home, which is being caused by the government's failure to live within its means. I have saved and invested in my home and I don't want the value taken away because of bad government policies.

I urge you to work for policies that will slow the growth of spending and change tax policy to reduce the deficit toward a balanced budget in 1984. Also, the Federal Reserve Board should be encouraged to increase the growth of credit 1 to 2 percentage points to help bring interest rates down.

Name

Street Address

City State ZIP

NATIONAL ASSOCIATION OF REALTORS®

ATTACHMENT 8.1

THE COMPARATIVE IMPACT OF THE ECONOMIC RECOVERY TAX ACT AND HIGH INTEREST RATES

In 1981, Congress passed the Economic Recovery Tax Act (ERTA) in an effort to stimulate savings and investment. A major feature of the new tax package directed at boosting investment, was the Accelerated Cost Recovery System under which tax lives for investment in equipment, commercial and industrial buildings and rental housing were reduced and certain tax credits enlarged or enhanced. ERTA also contained many other provisions having stimulative effects on savings and investment, including expansion of IRA and Keogh Plan provisions, reduced maximum tax rates on non-service income, and the All Savers Certificate program.

However, by far the largest component of ERTA in terms of revenue cost was the phased across-the-board reduction in individual income tax rates. While these individual rate reductions provide some modest incentive for savings and investment, most of the impact of these tax rate reductions is reflected in higher consumer spending. In all, almost 75 percent of the ERTA tax cuts are directed primarily at increased consumption and only 25 percent at directly stimulating savings and investment, one of the smallest proportions in the post war period.

Exploding Federal deficits and excessively tight credit growth policies have forced both long- and short-term interest rates to record levels, even after adjusting for inflation. Unfortunately, this has and will continue to offset the impact of ERTA in stimulating investment. As a result the share of both non-residential and housing investment in Gross National Product continues to fall, the very opposite of the intent of ERTA (see Table below).

Share of Investment and Consumption in GNP
(Percent)

	Actual			Forecast		
	Average 1970-79	1980	1981	1982	1983	1984
Private Consumption	62.4	63.2	63.5	65.0	65.0	64.7
Non-Residential Investment	10.4	10.7	10.7	10.5	10.5	10.8
Investment in Housing	4.2	3.2	3.0	2.0	3.3	3.6

ATTACHMENT 8.2

The reasons why high interest rates have more than offset the impact of ERTA on investment are demonstrated. The Accelerated Cost Recovery System, the main investment stimulus in the overall package, increased the rate of return (the incentive to invest) in new non-residential structures by about one percentage point--about the same effect as a one percent drop in long-term borrowing costs (see Table below). For rental housing, the increases in return were slightly larger--around 1.8 percentage points--although this still provided very little incentive for new construction because of the uneconomic return prevailing in the industry before ERTA was passed.

Impact of ERTA on Returns[1/] to New Investment

	Holding Period. Years			
	5	10	15	20
Non-Residential Construction	+1.0	+0.8	+1.3	+2.5
Rental Housing	+1.9	+1.8	+1.6	+1.3

1/ The effect of a one percentage point increase on after tax returns to investment is approximately equivalent to a one percentage point decrease in interest rates.

Against this, nominal interest rates have risen by almost five percentage points since 1979 and even after adjusting for inflation, are currently more than five percent above normal levels.

This does not imply that the investment incentives in ERTA were inappropriate; on the contrary, they were necessary to stimulate capital formation. However, Congress has the opportunity to enhance the impact of these incentives even more by significantly lowering the Federal deficit, which would allow the Federal Reserve Board to ease its excessively tight credit policies and bring about a sizeable reduction in interest rates.

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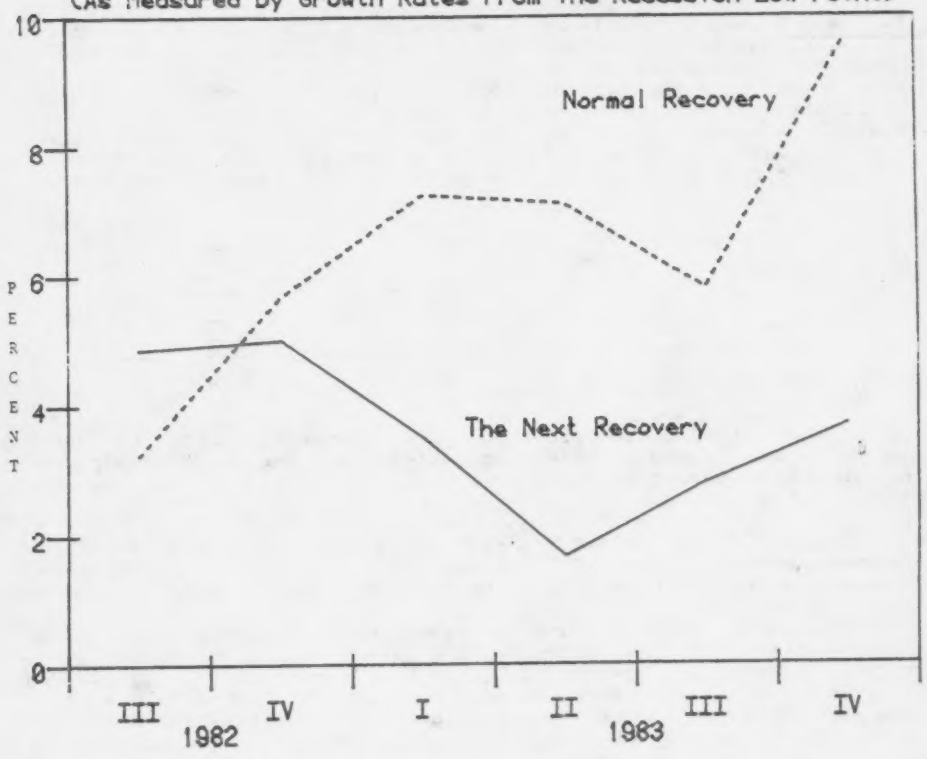
ATTACHMENT 9

The Next Recovery Will Be Weaker
Than Normal in the Post War Period
(As Measured By Growth Rates From The Recession Low Point)



SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Attachment 12-1

Table 1

U.S. ECONOMIC OUTLOOK

APRIL 1982

	QUARTERS							YEARS					
	Actual	Forecast						Actual			Forecast		
	81:4	82:1	82:2	82:3	82:4	83:1	83:2	1979	1980	1981	1982	1983	1984
AGGREGATE ECONOMY													
Gross National Product ($ billions)	2,998	3,004	3,039	3,117	3,213	3,298	3,368	2,414	2,626	2,926	3,093	3,416	3,771
Percent Change	4.6	0.7	4.8	10.6	12.9	11.0	8.8	12.0	8.8	11.4	5.7	10.4	10.4
Percent Change (without inflation)	-4.5	-4.4	-1.4	3.6	4.3	3.1	1.3	3.2	-0.2	2.0	-1.5	2.8	3.0
Consumption	-2.2	2.3	-0.9	3.8	3.5	4.2	0.7	2.9	0.5	2.5	0.9	2.9	2.6
Durables	-18.9	13.6	-6.0	21.9	13.4	3.0	-7.0	0.2	-7.4	2.6	0.7	5.5	3.8
Nondurables	-0.1	-1.4	0.1	1.5	1.3	2.5	1.9	2.6	1.1	2.5	0.3	1.7	1.8
Services	1.7	2.2	-0.1	0.8	2.3	6.0	2.2	4.1	2.6	2.6	1.5	2.1	2.9
Residential Investment	-27.5	-3.4	18.1	36.5	49.1	19.8	-2.5	-5.2	-18.6	-6.1	-4.7	18.3	6.9
Nonresidential Investment	-2.9	-13.8	-9.5	-2.3	4.9	4.3	2.1	6.5	-3.0	2.5	-5.3	2.6	6.0
Structures	9.2	-14.7	-12.3	-7.3	-4.3	-0.3	1.2	8.7	-0.1	9.4	-4.5	-2.2	2.3
Equipment	-7.9	-13.4	-8.1	0.1	9.4	6.5	2.5	5.5	-4.2	1.3	-5.6	4.9	7.7
Exports	-6.6	-6.4	0.1	1.2	4.1	5.2	6.4	15.2	9.6	-0.4	-3.1	4.6	5.0
Imports	4.5	2.3	1.2	4.3	7.8	7.3	4.5	6.0	-0.1	5.9	4.2	5.6	4.3
Government Purchases	10.2	-1.2	-6.6	-2.0	-1.3	-2.1	-0.5	1.5	2.9	0.6	-0.7	-1.5	0.5
Consumption (% of GNP)	63.9	65.0	65.1	65.1	65.0	65.1	65.0	62.8	63.2	63.5	65.0	65.1	64.9
Residential Investment (% of GNP)	2.6	2.6	2.8	3.0	3.2	3.4	3.3	4.0	3.2	3.0	2.9	3.3	3.5
Nonresidential Investment (% of GNP)	10.9	10.6	10.4	10.2	10.2	10.0	10.3	11.0	10.7	10.8	10.3	10.3	10.6
Inventory Change ($ billions)	9.4	-17.3	-7.1	2.1	9.6	7.0	12.8	17.8	-5.9	16.2	-3.4	10.6	19.5
Mfg. Capacity Utilization Rate (%)	75	72	71	72	74	75	75	86	79	79	72	75	76
Auto Sales (millions of units)	7.4	8.2	7.5	8.4	8.9	9.1	9.0	10.6	9.0	8.6	8.3	9.2	9.5
Manufacturing Industrial Production (% change)	-18.5	-13.9	0.1	9.8	11.5	7.7	2.3	4.8	-4.5	2.4	-5.3	6.7	4.4
Common Market	4.4	-0.6	0.1	3.1	4.1	3.8	2.3	4.7	0.2	-2.2	0.9	2.8	2.1
Japan	11.9	3.4	4.9	3.1	5.9	8.3	6.0	8.2	8.8	3.1	5.4	5.3	2.9
Employment (millions)	100.0	99.4	99.3	99.6	100.3	100.9	101.5	98.8	99.3	100.4	99.7	101.9	104.5
Unemployment Rate (%)	8.4	8.8	9.3	9.5	9.3	9.2	9.1	5.9	7.2	7.6	9.2	9.0	8.6
Disposable Income per Household (average)	26,885	27 183	27,592	28,512	29,147	29,780	30,278	21,565	23,748	26,042	28,109	30,834	33 610
Percent Change -- Year Ago (w/o inflation)	1.2	0.5	0.6	2.0	2.3	2.9	2.6	2.2	-0.1	1.2	1.3	2.6	2.1
Total Taxes per Household (average)	13,536	13,401	13 527	13,471	13 747	13,930	14 128	11 108	12 087	13,477	13,537	14,100	15,326
Percent Change -- Year Ago	6.7	0.4	1.1	-1.3	1.6	4.0	4.4	10.5	8.6	11.8	0.4	4.2	6.6
Percent of Disposable Income	50.3	49.3	49.0	47.2	47.2	46.8	46.7	51.5	50.8	51.8	48.2	45.8	44.7
Household Debt as Percent of Disposable Income	76.5	76.7	76.5	75.2	75.1	75.2	75.6	80.2	79.4	77.5	75.9	75.0	75.2
Consumer Price Inflation (CPI)	7.8	4.2	5.6	7.2	8.2	8.6	8.5	11.3	13.5	10.3	6.9	8.2	8.5
Gross National Product Inflation (GNP Deflator)	9.5	5.4	6.3	6.8	8.3	7.6	7.4	8.5	9.0	9.2	7.3	7.4	7.2
Personal Consumption Inflation	7.6	5.5	5.2	6.2	6.9	7.5	7.1	8.9	10.2	8.3	6.5	6.9	6.8
Residential Construction Inflation	6.4	8.3	7.7	8.9	10.1	9.9	9.9	12.8	9.4	6.9	7.7	9.6	8.6
Nonresidential Construction Inflation	10.2	6.9	7.7	9.4	10.6	10.6	10.6	12.6	13.4	9.5	9.4	10.1	9.9
Producers Price Inflation (WPI)	3.7	3.9	3.0	6 6	9.2	9.2	8.-	12 5	14.1	9.1	3.4	9.2	8.4
Compensation per Manhour (% change)	6.2	9.1	7.6	7.5	8.1	8.5	8.4	9.7	9.9	10.0	8.1	8.3	9.0
Productivity (% change)	-6.6	-3.0	-0.3	4.0	2.4	2.6	1.7	-0.7	-0.3	0.9	-1.6	2.4	1.8
Unit Labor Cost (% change)	13.8	12.7	7.9	3.3	4.5	5.7	6.6	10.4	10.3	9.0	9.8	5.8	7.1
Unit Capital Cost (% change)	8.8	8.4	8.1	7.8	7.6	7.5	7.5	11.3	11.3	9.8	8.0	7.6	8.4
Before Tax Corporate Profits ($ billions)<1>	241	203	194	209	224	236	241	255	258	262	208	246	274
Corporate Tax Liability	99	84	84	99	65	67	69	88	82	78	58	70	77
"Windfall Profits" Tax Receipts	26	24	21	22	24	22	21	0	13	29	23	22	23
Inventory Valuation Adjustment	-22	-5	-9	-14	-19	-24	-22	-43	-46	-28	-12	-25	-34
Capital Consumption Adjustment	-13	-10	-7	-3	3	1	1	-16	-17	-14	-5	1	2
After Tax Profits	145	123	119	128	136	147	151	168	163	156	127	154	174
Profits from Current Production (with IVA, CCA)	110	108	104	111	117	124	129	109	100	114	110	130	143
Adjusted for Inflation (81:4 base)	110	107	101	106	110	114	117	134	113	118	106	116	119
Percent Change - Year Ago	3.1	+13.1	-15.6	-12.1	-3.4	7.2	15.7	-1.6	-15.7	4.2	-10.5	10.1	2.5
Per Unit of Output (% of GNP)	3.7	3.6	3.4	3.5	3.6	3.8	3.8	4.5	3.8	3.9	3.5	3.8	3.8
Effective Corporate Tax Rate (%)<1>	39	36	35	36	37	36	36	45	45	41	36	36	36
Federal Tax Receipts (unified basis)	586	534	725	688	568	671	777	481	533	622	604	660	[illegible]
Federal Expenditures (unified basis)	779	711	723	708	770	756	796	909	601	695	727	787	852
Deficit (-) or Surplus (unified basis)	-203	-177	2	-116	-201	-213	-19	-28	-68	-75	-123	-126	-141
$ of GNP	-6.8	-5.9	.1	-3.8	-6.3	-6.5	-0.6	-1.2	-2.6	-2.6	-4.0	-4.3	-3.8
Net Personal Savings	-28.6	-27.1	3.4	-18.8	-31.1	-34.2	-3.1	-9.3	-18.1	-17.1	-27.9	-30.9	-[illegible]
% of Disp. Private Savings	+12.2	+6.7	.1	+5.2	+8.7	+9.2	+0.8	+2.8	+4.0	+3.9	+5.8	+5.8	+5.2

<1> Relates to "Base of windfall" profits tax in domestic crude oil production.

Source: Data base 1960 to the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Projections are DRI estimates by Dr. Alan Greenspan, Kenneth Gaffin, and Diane Swonk.

Attachment 11.2

Table 2

REAL ESTATE AND FINANCIAL MARKETS

APRIL 1982

	QUARTERS							YEARS				
	Actual	Forecast						Actual			Forecast	
	81:4	82:1	82:2	82:3	82:4	83:1	83:2	1979	1980	1981	1982	1983	1984
REAL ESTATE MARKETS													
Existing Single-Family Home Sales (thousands)	1,923	1,960	2,166	2,490	2,742	2,888	2,972	3,701	2,881	2,352	2,339	3,067	3,561
Percent Change - Year Ago	-34.6	-24.6	-17.6	10.5	42.6	47.4	37.2	-4.2	-22.2	-18.4	-0.5	31.1	16.1
Dollar Volume (billions)	149.2	153.3	174.8	207.9	225.9	242.6	257.3	237.6	209.7	183.3	190.5	268.1	340.0
Existing Home Prices - Median ($1000's)	68.2	67.2	69.7	72.4	71.7	73.3	75.7	55.7	62.2	66.4	70.2	76.3	83.7
Percent Change - Year Ago	4.3	4.4	4.9	7.1	8.4	9.1	8.5	14.1	11.7	6.8	6.2	8.7	9.6
Monthly Mortgage Payment, P&I, 80%, 30 yr.)	795	779	794	770	785	816	810	433	588	742	772	222	901
Percent of Household Income	30	29	28	28	28	28	27	20	25	29	28	27	28
New Single-Family Home Sales (thousands)	402	386	465	522	610	610	562	704	545	437	471	591	617
Percent Change - Year Ago	-27.3	-26.1	2.1	41.3	26.8	32.1	20.9	-13.7	-22.5	-19.8	7.6	25.6	4.4
New Home Prices - Median ($1000's)	69.5	70.3	71.7	73.5	75.6	77.6	79.7	62.7	64.7	68.9	72.6	80.8	88.8
Percent Change - Year Ago	5.2	4.8	3.9	5.4	8.8	10.4	11.2	12.5	3.1	6.4	5.7	11.0	9.9
New Home Prices--Mean ($1000's, Quality Adjusted)	86.7	90.2	92.6	93.4	94.5	98.4	101.0	71.4	78.5	85.3	92.7	101.2	110.2
Percent Change - Year Ago	8.0	8.3	8.6	8.7	9.0	9.1	9.1	14.8	10.1	8.6	8.6	9.2	8.9
New Mortgage Commitments ($ billions)	45.3	52.2	64.8	81.2	99.9	83.8	65.6	129.0	87.1	60.2	74.5	60.2	88.9
Percent Change - Year Ago	-52.6	-33.2	-6.6	69.5	120.7	60.4	1.2	-8.8	-32.5	-30.9	23.8	-19.2	47.5
Mortgage Debt Outstanding ($ billions)	1,555	1,588	1,620	1,657	1,696	1,730	1,763	1,266	1,401	1,512	1,640	1,780	1,944
Homeowners' Equity ($ billions)	2,984	3,017	3,043	3,083	3,154	3,245	3,344	2,511	2,747	2,908	3,075	3,398	3,810
Housing Inventory (millions)	84.7	84.8	84.8	85.0	85.1	85.3	85.5	82.8	83.8	84.5	84.9	85.6	86.4
Private Housing Starts (thousands)	865	922	1,016	1,200	1,403	1,343	1,357	1,717	1,298	1,100	1,135	1,357	1,500
Single-Family	537	622	668	822	987	914	932	1,172	855	714	775	928	1,052
Multi-Family	328	301	347	378	417	428	424	546	443	386	361	430	442
Subsidized	157	147	143	136	113	75	57	175	173	115	135	52	10
Mobile Home Shipments (thousands)	207	202	196	211	234	247	240	276	223	240	211	238	240
Rental Vacancy Rate (%)	5.0	5.0	4.9	4.8	4.8	4.7	4.7	5.4	5.4	5.0	4.9	4.7	4.6
Unsold New Homes (% of sales)	76.6	76.3	76.9	71.6	67.3	64.5	67.2	59.6	68.4	75.6	73.0	66.6	71.0
Office Vacancy Rate (%)<1>	4.8	5.0	5.0	4.9	4.9	4.8	4.7	4.4	3.7	4.3	5.0	4.6	4.2
Industrial Vacancy Rate (%)<1>	3.8	4.0	4.1	4.2	4.4	4.3	4.3	3.0	3.5	3.7	4.2	4.3	3.9
New Commercial Building Construction (% Ch Value)	9.8	-10.9	2.2	1.0	4.1	10.5	17.2	33.8	21.7	11.7	0.8	9.4	13.7
New Industrial Building Construction (% Ch Value)	6.4	-29.8	-30.9	2.7	19.4	14.3	17.9	37.2	-6.7	20.9	-6.0	12.4	24.5
FINANCIAL MARKETS													
Personal Savings Rate (%)	6.1	5.6	6.2	7.2	7.1	6.7	6.7	5.3	5.6	5.3	6.5	7.1	7.6
Money Supply (M1A) (% change)	5.9	11.4	2.1	6.1	2.4	4.4	2.1	7.8	6.2	6.7	5.8	3.7	4.3
Money Supply (M2) (% change)	9.2	10.5	9.0	7.9	9.5	9.1	7.4	8.9	8.7	9.1	8.7	8.0	8.6
Total Time and Savings Deposits (% change)	5.2	6.0	7.0	8.8	8.4	7.4	6.4	8.6	7.5	8.7	8.7	7.5	7.9
Selected Interest Rates (Percent)													
New Home Mortgage Commitment Rate	17.35	17.29	16.10	15.80	16.29	16.59	15.91	11.27	14.00	16.71	16.37	16.03	15.01
Real Mortgage Rate	8.44	11.94	9.82	9.05	9.33	9.20	9.52	3.21	4.24	7.84	9.71	8.53	9.00
Assumption Rate	13.54	11.97	11.59	11.78	11.92	12.11	12.26	NA	10.95	12.35	11.82	11.91	11.16
Seller Take Back Mortgage Rate	13.20	12.60	12.20	12.40	12.56	12.75	12.70	NA	11.25	13.15	12.44	12.54	11.75
Blended Rate	15.30	14.53	13.92	13.60	14.16	14.40	14.21	10.36	12.03	14.15	14.13	14.11	14.30
Corporate Bond Rate (AAA)	14.92	15.00	14.63	14.26	14.35	14.37	14.28	9.63	11.94	14.17	14.56	14.19	14.08
Government Bond Rate	14.11	14.19	12.62	12.34	12.84	12.84	13.12	9.62	11.51	14.14	13.50	12.14	12.39
Real Long-term Government Bond Rate	4.61	3.33	4.35	5.59	4.58	5.34	5.24	4.56	4.15	5.47	5.34	5.85	5.38
Federal Funds Rate	13.69	13.97	12.59	12.20	13.77	14.86	14.50	11.19	13.36	16.38	13.12	13.67	14.81
3 Month Treasury Bills	12.55	12.34	11.74	11.38	12.53	13.43	14.41	10.07	11.43	14.03	12.13	12.99	14.11
1 Year Treasury Bills	13.66	14.28	12.92	12.22	13.11	13.96	14.61	10.67	12.06	14.79	13.06	14.15	14.71
Commercial Paper Rate	14.24	14.73	13.44	13.18	13.83	14.62	14.96	11.37	13.66	15.73	13.99	13.64	14.47
Rate on Money Market Fund Shares	13.61	13.45	12.55	12.18	12.86	13.58	13.54	10.12	12.19	15.28	13.20	13.32	13.87
Prime Rate	15.75	15.67	14.26	13.87	13.96	13.89	13.87	14.87	15.27	18.87	15.81	15.57	15.81

<1> Historical data estimates of Data Resources.

Source: Those data used by the National Association of Realtors, etc. data resources, inc. (DRI) models and other sources by DRI each month. Other values, except data and some [illegible].

ATTACHMENT 11

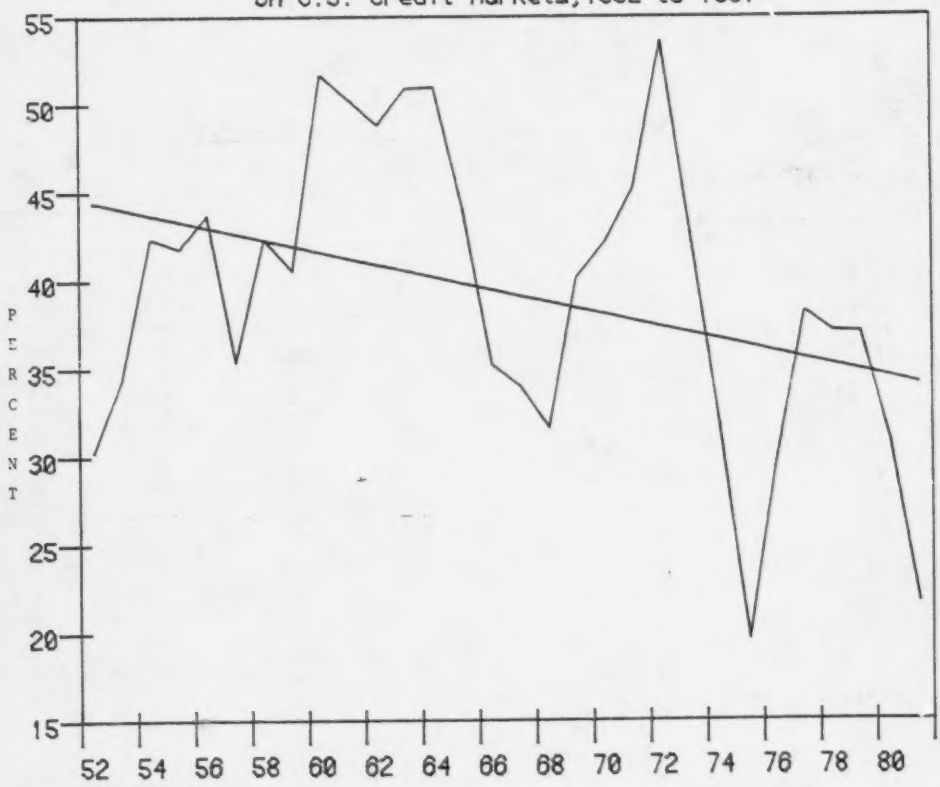
HOUSING AS A SHARE IN GNP

PERIOD		HOUSING SHARE OF NATIONAL OUTPUT
1950 - 1959 Average		4.8
1960 - 1969 Average		4.4
1970		3.8
1971		4.8
1972		5.4
1973		5.0
1974		3.9
1975		3.4
1976		3.9
1977		4.4
1978		4.3
1979		4.0
1980		3.2
1981		3.0
1982	(Forecast)	2.9
1983	(Forecast)	3.3
1984	(Forecast)	3.6

Source: National Income Accounts and estimates by the National Association of Realtors®.

ATTACHMENT 12

Share of Housing In Total Funds Borrowed
On U.S. Credit Markets, 1952 to 1981



SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

ATTACHMENT 13

OVERRUN IN FEDERAL SPENDING CONTRASTED
TO PRESIDENTS' ORIGINAL COMMITMENTS
(Dollars in Billions)

Fiscal Year	Initial (January) Budget Estimate	Actual Budget Spending	Spending Overrun	
			Percentage	Amount
1972	$229.2	$232.0	1.2	$2.8
1973	246.3	247.1	0.3	0.8
1974	268.7	269.6	0.3	0.9
1975	304.4	326.2	7.1	21.8
1976	349.4	366.4	4.9	17.0
1977	394.2	402.7	2.2	8.5
1978	440.0	450.8	2.4	10.8
1979	500.2	493.6	-1.3	-6.6
1980	531.6	579.6	9.0	48.0
1981	615.8	660.5	7.3	44.7
1982	695.3 (3/10/81)	May 15 -Congress 695.5e	0.0e	0.2e
		July 15 -President 704.8e	1.4e	9.5e
		Sept. 10 -CBO 723.0e	4.0e	27.7e
		Sept. 24 -President 709.3e	2.0e	14.0e
		Feb. 8 -President 729.2ef	4.9e	33.9e
		-REALTORS® 742.7ef	6.8e	47.4e
72-82 Average			3.7e	17.8e
1983	762.1f	Feb. 25 -CBO 785.1ef	1.7	13.0

e = estimate
f = adjusted for comparability by increasing $4.4 billion in 1983 and $3.9 billion in 1982 for SMI and VSI Insurance premiums excluded from spending figures starting in 1983 budget.

SOURCE: Budgets of the U.S. Government, First Concurrent Budget Resolution 1982, Congressional Budget Office Reports, and public statement of the President.

ATTACHMENT 14

EXCERPT FROM STATEMENT OF
THE NATIONAL ASSOCIATION OF REALTORS®
TO SENATE BUDGET COMMITTEE

April 6, 1981

Because of the need for keeping spending reductions and tax relief linked and the need to stimulate savings, we recommend limiting across-the-board personal income tax relief to 5 percent annually over the next 3 years, starting no sooner than July 1981.

ATTACHMENT 15

NATIONAL ASSOCIATION OF REALTORS

REALTOR®

John R. Wood, President
Julio S. Laguarta, First Vice President
Jack Carlson, Executive Vice President

925 15th Street, N.W., Washington, D.C. 20005
Telephone 202 637 6800

January 21, 1981

Dear Association Member:

For more than 14 months now, the NATIONAL ASSOCIATION OF REALTORS®, on behalf of its more than 750,000 members, has been stressing the effect of poor economic policies on the housing industry.

However, it is not just our industry that has suffered and continues to be damaged by high inflation. Virtually every area of our nation's economy is feeling the burden of the poor mix of fiscal and monetary policies.

On both January 16 and January 19 we offered recommendations to the new administration and Congress and we stressed that we are willing to sacrifice in areas that affect housing and other real estate because in the long run we are confident our industry will benefit.

I am taking this opportunity to ask you to join in this approach -- sacrifice now for future economic strength -- and have enclosed the advertisement we employed and some of our material. First, insist that our government slow overall spending, reduce the federal deficit, provide tax relief directly for encouraging savings and investment as proposed in the attached advertisement we placed in major newspapers January 19. Second, do your part by recommending programs that benefit your industry be trimmed, as we have.

If we can be helpful to you, please call me at 202/637-6891.

Together we can get our economy and our industries back on track. And now is the most appropriate time to begin.

Sincerely,

Jack Carlson

Jack Carlson

Enclosures

ATTACHMENT 16

NATIONAL ASSOCIATION OF REALTORS HOUSING PROPOSALS

America's Housing Industry is in a Depression:

- The current slump in home sales is five times worse than at any time in the post-war period...
- Economic activity associated with housing construction and sales which has been lost in the last three years amounts to almost $200 billion...
- Over two million housing and related jobs have been lost since 1980...
- Only five percent of non-homeowners can qualify for an 80 percent mortgage on a median-priced home, and lenders have effectively shut the window on mortgage lending activity.

The NATIONAL ASSOCIATION OF REALTORS® recommends:

- Provide administrative and legislative changes to the Mortgage Revenue Bond program to increase the number of bonds that can be issued and make mortgages provided by the bonds more widely available. 400,000 families could achieve homeownership under this program within one year of the date these changes are adopted.
- Allow first-time homebuyers a credit against Federal income taxes of up to $5,400 on the purchase of a home between March 1 and December 31, 1982. The result would be that more than 250,000 first-time homebuyers, who would not otherwise have been able to afford a home, could purchase a home in 1982.
- Allow mortgage lenders a credit against federal income taxes of up to $5,400 if they make home mortgage loans during the period March-December, 1982. In order to qualify for the credit, lenders would be required to use the amount of the credit to decrease the effective rate of interest on the mortgage by three percentage points for a three-year period.

Where's the Money Coming From?

Much, if not all, of the cost of such a program could be recouped through a curtailment of the existing All Savers program as of March 31, 1982, instead of its current ending date of December 31, 1982.

Revenue loss estimates for the All Savers program, at the time of enactment, were $3.3 billion. As of this date, some $700 million of that amount has been "consumed" by the issuance of All Savers Certificates, leaving $2.6 billion unused by the program. Current estimates are that the program will not be significantly expanded between now and March 31.

POSSIBLE DOLLAR SAVINGS TO HOMEBUYER
ON MONTHLY MORTGAGE PAYMENT FOR PRINCIPAL AND INTEREST
IF TAX CREDIT IS USED TO "BUY DOWN" INTEREST RATE

MORTGAGE INTEREST RATE WITHOUT CREDIT	MORTGAGE INTEREST RATE WITH CREDIT	MONTHLY PAYMENT FOR PRINCIPAL AND INTEREST WITHOUT CREDIT	MONTHLY PAYMENT FOR PRINCIPAL AND INTEREST WITH CREDIT	DOLLAR SAVINGS PER MONTH	DOLLAR SAVINGS PER YEAR
17%	14%	$855	$710	$145	$1740
16	13	806	663	143	1716

ATTACHMENT 17.1

REALTORS® ECONOMIC PACKAGE

IMPACT OF SUBSTANTIALLY LOWER DEFICITS
ON THE ECONOMY 1/
(Calendar Years)

	1982	1983	1984
Long Term Interest Rates (% Points)	-0.5	-1.6	-2.3
Housing Starts (Units)	105,000	350,000	550,000
Existing Home Sales (Units)	200,000	650,000	800,000
Investment in New Plant and Equipment (% Change)	0.6	2.8	3.5
Real Gross National Product (% Change)	0.3	0.6	0.9
Consumer Inflation (% Points)	-0.2	-0.4	-0.5
Spendable Income per Household ($)	$84	$185	$302
Employment	100,000	400,000	800,000

1/ Together with less restrictive credit policy

IMPACT OF INTEREST TAX CREDIT
(Calendar Years)

	1982	1983
Housing Starts (Units)	70,000	20,000
Existing Home Sales (Units)	155,000	
Real Gross National Product (% Change)	0.2	-
Employment	100,000	-

IMPACT OF EXPANDED MORTGAGE REVENUE BOND
(Calendar Years)

	1982	1983
Housing Starts (Units)	62,000	71,000
Existing Home Sales (Units)	123,000	142,000
Real Gross National Product (% Change)	0.2	0.3
Employment	150,000	200,000

ATTACHMENT 17.2

REALTORS® ECONOMIC PACKAGE

COMBINED IMPACT 2/
(Calendar Years)

	1982	1983	1984
Long Term Interest Rates (% Points)	-0.4	-1.3	-1.9
Housing Starts (Units)	200,000	450,000	550,000
Existing Home Sales (Units)	450,000	750,000	800,000
Investment in Commercial, Industrial and Agricultural Structures and Equipment (plant and equipment) % change	0.5	2.6	3.3
Real Gross National Product (% change)	0.5	0.8	1.2
Consumer Price Inflation (% points)	-0.2	-0.3	-0.2
Spendable Income per Household ($)	$140	$247	$403
Employment	200,000	600,000	800,000

2/ Aggregate impact differs from the sum of the components because of the interaction effect.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

JOINT STATEMENT OF

ATTACHMENT 1#

AMERICAN BANKERS ASSOCIATION
MORTGAGE BANKERS ASSOCIATION OF AMERICA
NATIONAL ASSOCIATION OF HOME BUILDERS
NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS
NATIONAL ASSOCIATION OF REALTORS
U.S. LEAGUE OF SAVINGS ASSOCIATIONS

FEBRUARY 25, 1982

Prolonged high interest rates are creating an economic and financial crisis in this country. In order to bring interest rates down, immediate action must be taken to reduce massive federal budget deficits. More than anything else, it is the spectre of an overwhelming volume of deficit financing which haunts housing and financial markets and poses the threat of economic and financial conditions not seen since the 1930s.

Given these circumstances, there is no alternative to: (1) slowing down all spending, not excluding defense and entitlement progams; and, if necessary, (2) deferring previously enacted tax reductions or increasing taxes. In order to have the necessary impact on financial markets, these actions should be taken prior to any increase in the ceiling on the federal debt.

Even with these actions, the restoration of financial stability and safety will be a prolonged process. It is necessary, therefore, to adopt immediate but temporary measures to address the critical problems of the industries which finance, market and produce housing for American families. These industries have unfairly borne the brunt of destructively high interest rates. Unless immediate and effective short-run measures are adopted, the continued devastation of these industries will, directly and indirectly, aggravate the federal budget deficit and greatly increase the prospect of a general economic and financial crisis.

In times of past crises in this nation, our political leaders have come together in a bipartisan manner to develop effective solutions in the common interest. Our nation is at such a time now. There will be no political winners if the Administration and the Congress fail to accommodate differences and cooperate in dealing with current serious economic problems. The threat to our nation demands prompt, effective and bipartisan action.

Llewellyn Jenkins, President
American Bankers Association

Robert B. Masterton, Chairman
Mutual Savings Banks

James F. Aylward, President
Mortgage Bankers Association

Julio S. Laguarta, President
National Association of Realtors

Fred Napolitano, President
National Association of Home Builders

Roy G. Green, President
U.S. League of Savings Associations

Bill Ellingsworth (202)383-1011

Washington (March 29, 1982)-- Following is a statement by Julio S. Laguarta, president of the National Association of Realtors.

RESOLUTION: The National Association of Realtors supports the President for his new policies for a healthy economy and housing industry. In particular:

- We endorse the President's commitment to reduce the federal deficits and borrowing which would help bring down interest rates and allow all sectors of the economy to prosper, in particular the interest-sensitive areas such as housing;
- We endorse the President's statement on the importance of fostering private property rights;
- We endorse the President for supporting homeownership--for shelter to nurture our families, for encouraging higher savings and investment;
- We support the President for removing barriers to the use of the Mortgage Revenue Bonds, which funds have already been authorized by the Congress and included in the estimated deficits.
- We commend the President for removing barriers for the effective use of unsubsidized programs which help housing, such as improvements in the Federal Housing Administration programs, commitment to continue the Government National Mortgage Association programs, and removal of barriers in ERISA regulations for use of pension funds for residential mortgages.

Upon this foundation, we suggest that the federal deficit be reduced by one-third below current estimates--by cutting entitlements, defense and other programs and, if necessary, by deferring tax relief.

We recommend further that the deficient All-Savers Certificate program be terminated and the resources be used for a tax credit for first-time homeowners.

We do not need a hand out, rather we need housing to offer a hand to pull this nation out of recession as it always has.

Chairman ROSTENKOWSKI. Thank you. Mr. Oswald, you may proceed.

STATEMENT OF RUDOLPH A. OSWALD, DIRECTOR OF ECONOMIC RESEARCH, AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE

Mr. OSWALD. Thank you, Mr. Chairman. Accompanying me this morning is Steve Koplan of our legislative department.

We appreciate this opportunity to present the AFL–CIO's views on the tax and revenue proposals contained in the Reagan administration budget for fiscal year 1983.

The Reagan administration tax legislation provided huge tax cuts for wealthy individuals and corporations, and gave only a token cut to the rest of America. The AFL–CIO is here today to offer an alternative proposal which includes retaining the full tax cut for almost all those who earn $40,000 per year or less and providing a $700 per year cut to those who earn more than that amount. This revenue and other AFL–CIO proposals would recapture sufficient revenues to restore worker-assistance programs that have been weakened or destroyed, and take a large stride toward restoring tax equity.

The AFL–CIO proposal would raise revenues equitably, thus providing funds for programs that the Reagan administration would cut further, as well as funds for programs to put jobless Americans back to work. A means to cut the deficit is also proposed by the AFL–CIO through the closing of some of the most serious tax loopholes. Further, if defense needs are to require additional funding, the AFL–CIO proposes that these added funds be raised by means of a progressive tax.

The administration tax proposals add up to a melange of gimmicks and token devices to make the deficit appear smaller and defuse the rapidly growing chorus of criticism over last year's tax bill.

The AFL–CIO's alternative tax program would correct the worst inequities in last year's tax legislation and provide revenues necessary to meet national priorities, protect workers and the poor and fund programs to provide jobs, incomes, and purchasing power to lift the economy out of the recession.

The specific tax measures proposed by the AFL–CIO are, one, to cap the 1982 and 1983 tax cuts at $700 per family. This measure would add a substantial element of equity to the 1982 and 1983 individual income tax cuts by trimming back on some of the huge cuts that would otherwise flow to those at the upper ends of the income scale.

The cap would have little or no effect on most families with incomes of $40,000 or less. Above that amount, most taxpayers would be denied a portion of the reduction but their taxes in 1982 would still be $700 below pre-1981 levels and they would still receive a cut in 1983.

We have attached a table that illustrates what the effect would be for families of different sizes and different income levels. For ex-

ample, a family of four at $40,000 would retain its full tax cut, and at $45,000 only $93 out of the $793 reduction is forgone.

In the higher income brackets, of course, the proposals have a substantial effect. The $6,223 cut scheduled for taxpayers with a $100,000 salary and a $50,000 capital gain is reduced to $1,400 next year instead of that $6,000.

We also propose a number of other changes, to repeal the leasing of tax credits by corporations, to repeal the broadened loopholes in the oil windfall profits tax as incorporated in last year's tax bill. We would urge modification of the estate and gift tax provisions that were widened last year to recapture some of the revenue loss.

The AFL-CIO also urges the repeal of the indexation provisions scheduled to go into effect in 1985.

Let me just say a word about taxes and the defense budget. We remain convinced that the American economy can sustain a strong national defense without shortchanging vital social programs that reflect the values of our society. We do feel that the administration policies have set up a situation where destructive guns-versus-butter debates have been revived and the administration has clearly opted for the former.

We feel that the defense budget should be subjected to the same close scrutiny that social programs have always undergone and if Congress determines that higher levels of defense spending in fiscal year 1983 are required, that this increase should be fully financed by a progressive surtax on income.

At least one-third of this tax should be provided by an inescapable levy on gross corporate earnings. In this way, defense needs can be met without adding to the Federal deficit or cutting food stamps, unemployment benefits, job and training programs, mass transit, or other already battered social programs.

If the Congress wishes to reduce the deficit, the AFL-CIO suggests a list of specific loopholes which if closed or trimmed could generate substantially more revenue and would represent a beginning step toward tax justice.

Let me just note one of the first items that needs to be changed is the foreign tax credit, an item often not included in the list of tax expenditures. The foreign tax credit, as you know, allows U.S. corporations to credit foreign income taxes on a dollar-for-dollar basis against the U.S. tax liability.

We feel income taxes paid by U.S. corporations to foreign governments should be treated as costs of doing business and deducted from income just like the taxes paid to state and local government. If that loophole were closed, at least $10 billion of annual revenues could be generated.

Other means of raising revenues could take place through repealing the deferral privilege which allows multinational corporations to defer their income tax until the earnings are returned to the United States.

Further funds could be raised by eliminating the Domestic International Sales Corporation, by ending depletion allowances and the immediate expenses of certain drilling costs, by reducing the investment tax credit to the 7-percent level that it had been prior to the increase to 10 percent, by limiting the lower tax rates on the first $100,000 of corporate income to small corporations rather than

providing the same benefit to all corporations, and by phasing out the capital gains preferences.

We are convinced that the crazy quilt combination of the Reagan administration's huge tax cuts, dismantled programs and skyhigh interest rates is the direct cause of the present deep recession, high and rising levels of joblessness, and the budgetary mess. We are also convinced that the inequities and imbalances of these programs have seriously undermined the capacity of the economy to turn itself around and regain the strength and resiliency necessary to move forward.

The administration's failed economic recovery program promised a supply-side outpouring of investment, output, jobs and public revenue as the result of the 1981 tax cut. It promised that 1.4 million more people would be at work by the end of the year, and the national output would grow by 4.2 percent.

Instead, we have 1.2 million less people at work now than we had last July. Instead of the outpouring of gain we have the greatest depression since the Great Depression of the 1930's. Since last July the number of unemployed has increased by 1.8 million—30 percent of industrial capacity is idle, and factory output is down 8.6 percent. Construction industry unemployment is above 18 percent. Housing starts are at historic lows, and last week the Commerce Department reported business spending plans, despite the $14 billion that will flow in business tax incentives, is likely to fall by one percent in real terms.

Despite this, the Reagan administration tells America we should wait. The investment tax cuts were made retroactive to January 1981, with no positive results thus far in either 1981 or 1982. The capital gains reductions were made effective in June of 1981 with no beneficial effects shown for the economy. While we are asked to wait 9.3 million Americans are jobless, thousands of Americans have had their mortgages foreclosed and business and personal bankruptcies are at a 40-year high.

We believe a major effort must be undertaken to create jobs and reverse the economy's downslide. At the same time, interest rates must be lowered and the Federal Government's fiscal position should not be exacerbated.

Mr. Chairman, in our view this adds up to a need for a carefully balanced combination of direct targeted programs that can fight recession and cushion its effects and drastic corrective surgery on last year's tax bill. We are convinced that a complete about-face is essential to begin to revitalize the Nation, to add a critically needed element of fair play to national economic policy and to prevent a worsening of the recession.

Mr. Chairman, I have attached the statement of the AFL–CIO executive council to my statement, which provides the compete details of an alternative to the Reagan economic policies and I ask that it be made part of the record.

Chairman ROSTENKOWSKI. Without objection, it is so ordered.

[The prepared statement follows:]

STATEMENT BY DR. RUDOLPH A. OSWALD, DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

We appreciate this opportunity to present the AFL–CIO's views on the tax and revenue proposals contained in the Reagan Administration Budget for fiscal year 1983.

The Reagan Administration tax legislation provided huge tax cuts for wealthy individuals and corporations and gave a token cut to the rest of America. The AFL–CIO is here today to offer an alternative proposal which includes retaining the full tax cut for almost all who earn $40,000 per year or less and providing a $700 per year cut to those who earn more than that amount. This revenue and other AFL–CIO proposals would recapture sufficient revenues to restore worker-assistance programs that have been weakened or destroyed—and take a large stride toward restoring tax equity.

The AFL–CIO proposal would raise revenues equitably, thus providing funds for programs the Reagan Administration would cut further, as well as funds for programs to put jobless Americans to work. A means to cut the deficit is also proposed by the AFL–CIO through the closing of some of the most serious tax loopholes. Further, if defense needs are to require additional funding, the AFL–CIO proposes that these added funds be raised by means of a progressive tax.

The Administration tax proposals add up to a melange of gimmicks and token devices to make the deficit appear smaller and defuse the rapidly growing chorus of criticism over last year's tax bill.

The AFL–CIO's alternative tax program would correct the worst inequities in last year's tax legislation and provide revenues necessary to meet national priorities, protect workers and the poor and fund programs to provide jobs, incomes and purchasing power to lift the economy out of recession.

The specific tax measures proposed by the AFL–CIO are:

CAP THE 1982 AND 1983 TAX CUTS AT $700 PER FAMILY

This measure would add a substantial element of equity to the 1982 and 1983 individual income tax cut by trimming back on some of the huge cuts that would otherwise flow to those at the upper ends of the income scale. The cap would have little or no effect on most families with incomes of $40,000 or under. Above that amount, most taxpayers would be denied a portion of the reduction but their taxes in 1982 would still be $700 below pre-1981 levels and they would still receive a cut in 1983.

The attached table illustrates the effects of the proposals and shows, for example, that in 1982 a $40,000 family of four retains its full tax cut and at $45,000 only $93 out of the $793 reduction is foregone. In the higher brackets, of course, the proposals have a substantial effect—the $6,223 cut scheduled for 1983 for a taxpayer with a $100,000 salary and a $50,000 capital gain is reduced to $1,400—an amount that is still almost four times larger than the reduction for a $20,000 wage earning family of four.

We estimate that this proposal will recoup $25-30 billion of the revenue lost by the 1981 tax cuts.

REPEAL THE LEASING OF TAX CREDITS BY CORPORATIONS

The so-called "safe harbor leasing" rules have widened the definition of a tax qualified lease in a fashion which permits corporations that owe no taxes to, in effect, receive a tax cut anyway and substantially enlarges the tax benefits available to large and profitable businesses.

The revenue loss due to this provision will be nearly $7 billion by the end of fiscal year 1983 and by 1986 its cost will be $8.5 billion annually.

REPEAL THE LOOPHOLES IN THE OIL WINDFALL PROFITS TAX

The 1981 tax law provided a series of tax bonanzas to oil royalty owners and producers of "new" oil. The fiscal year 1982–1983 cost of these provisions is respectively, $1.3 and $1.7 billion rising to $3.6 billion in 1986.

MODIFY THE ESTATE AND GIFT TAX PROVISIONS

The 1981 Act through a variety of increases in credits, exemptions, rate cuts and valuation devices has effectively destroyed the estate and gift tax. Only the estates of the very wealthy—an estimated 3 percent—paid federal estate and gift taxes and as a result the heirs of these estates are the sole beneficiaries of this provision. The

AFL-CIO recommends that the provision be modified to raise at least $1 billion in additional revenue.

The AFL-CIO also calls for repeal of the indexation provisions scheduled to go into effect in 1985. These provisions amount to a permanent and continuing erosion of the tax base and would substantially damage the stabilizing impact of the tax structure during periods when the economy is overheating and generating inflationary pressures due to high levels of operation.

A word about taxes and the defense budget. We remain convinced that the American economy can sustain a strong national defense without shortchanging vital social programs that reflect the values of our society.

We do feel that the Administration's policies have set up a situation where a destructive guns-versus-butter debate has been revived and the Administration has clearly opted for the former. We feel that the defense budget should be subjected to the same close scrutiny that social programs have always undergone and if Congress determines that higher levels of defense spending in fiscal 1983 are required, this increase should be fully financed by a progressive surtax on income. At least one-third of this tax should be provided by an inescapable levy on gross corporate earnings. In this way, defense needs can be met without adding to the federal deficit or cutting food stamps, unemployment benefits, job and training programs, mass transit, or other already battered social programs.

If the Congress wishes to reduce the deficit, the AFL-CIO suggests a list of specific loopholes which if closed or trimmed could generate substantially more revenue and represent a beginning step toward tax justice.

Specifically:

Change the foreign tax credit to a deduction. The foreign tax credit provision allows U.S. corporations to credit foreign income taxes on a dollar-for-dollar basis against their U.S. tax liability. We feel income taxes paid by U.S. corporations to foreign government should be treated as costs of doing business and "deducted" from income just like the taxes paid to state and local governments. At least $10 billion of annual revenue could be generated through such action.

Repeal the deferral privilege which allows multinational corporations to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such time as the firm decides to bring the profits home. This loophole costs over $500 million per year and is a key factor in encouraging U.S. firms to operate overseas.

Eliminate the Domestic International Sales Corporation (DISC) gimmick which allows corporations to spin off into export subsidiaries in order to defer, perhaps indefinately, taxes on substantial portions of export profits at a revenue loss of nearly $2 billion per year.

End the depletion allowance and the immediate expensing of certain drilling costs to generate some $6 billion in revenue.

Reduce the Investment Tax Credit—currently the single most costly business tax preference—to its former 7 percent level. In view of the huge depreciation giveaways enacted last August there is no justification for maintaining this provision. Reducing the credit from 10 percent to 7 percent could raise over $7 billion.

Limit the lower tax rates that apply to the first $100,000 of corporate income to small corporations. Although this provision is typically justified as a device to help small business most of the benefits flow to the largest and most prosperous corporations, at an annual revenue loss of $7-8 billion.

Phase out capital gains preferences which put a ceiling of only 20 percent on the tax rate and completely exempts from the income tax such gains when they are passed on at death. This proposal would raise $12 billion.

Mr. Chairman, we recognize that the program we are urging is ambitious. It calls for a complete reversal of the tax policies of the past year and it requires a recognition that a major error was made and requires a will to correct it.

We are convinced that the crazy quilt combination of the Reagan Administration's huge tax cuts, dismantled programs and sky high interest rates is the direct cause of the present deep recession, high and rising levels of joblessness, and the budgetary mess. We are also convinced that the inequities and imbalances of these programs have seriously undermined the capacity of the economy to turn itself around and regain the strength and resiliency necessary to move forward.

The Administration's failed "Economic Recovery Program" promised a "supply-side" outpouring of investment, output, jobs, and public revenue as the result of the 1981 Tax Cut. It promised that 1.4 million more people would be at work by the end of the year, and the national output would grow by 4.2 percent.

Instead, the Reagan Administration has plunged the nation into the worst decline since the Great Depression and the end is nowhere in sight. Since last July, the number of unemployed has increased by 1.8 million; 30 percent of industrial capac-

ity is idle and factory output is down 8.6 percent. Construction industry unemployment is above 18 percent, housing starts are at historic lows and last week, the Commerce Department reported business spending plans—despite the $14 billion that will flow in business tax incentives—is likely to fall by 1 percent in real terms.

Despite this, the Reagan Administration tells America we should wait. The investment numbers were made retroactive to January 1981, with no positive results thus far in either 1981 or 1982. The capital gains reductions were made effective in June of 1981 with no beneficial effects shown for the economy. While we are asked to wait 9.3 million Americans are jobless, thousands of Americans have had their mortgages foreclosed and business and personal bankruptcies are at a 40-year high.

As for the Administration's tax proposals, if every single one of the 24 income, excise and employment tax provisions, user charges and collection fees were enacted as proposed, $15.9 billion in additional fiscal year 1983 revenue would be collected. This certainly is a respectable amount, but it falls far short of needs and adds up to nothing when measured against the need to restore some equity to the federal tax structure.

The highly publicized corporate minimum income tax, for example, does not even offset the revenue loss of the leasing provisions. The excise, employment taxes and user fees only add to inequity.

We believe a major effort must be undertaken to create jobs and reverse the economy's downslide. At the same time interest rates must be lowered and the federal government's dismal fiscal position should not be exacerbated.

Mr. Chairman, in our view, this adds up to a need for a carefully balanced combination of direct targeted programs that can fight recession and cushion its effects, and drastic corrective surgery on last year's tax bill.

We are convinced that a complete about face is essential to begin to revitalize the nation, to add a critically needed element of fair play to national economic policy and to prevent a worsening of the recession.

EFFECT OF THE AFL–CIO PROPOSAL TO CAP THE 1982–83 INDIVIDUAL TAX CUTS AT $700

Income	Pre-1981 law tax liability	1982 tax reduction			1983 tax reduction		
		Current law	AFL–CIO proposal	Difference	Current law	AFL–CIO proposal	Difference
$10,000:							
Family of 4	$550	$74	$74	(1)	$111	$111	(1)
Family of 2	900	114	114	(1)	171	171	(1)
Single	1,177	134	134	(1)	226	226	(1)
$20,000:							
Family of 4	2,013	228	228	(1)	371	371	(1)
Family of 2	2,457	268	268	(1)	459	459	(1)
Single	3,115	326	326	(1)	610	610	(1)
$30,000:							
Family of 4	3,917	405	405	(1)	744	744	(1)
Family of 2	4,477	465	465	(1)	844	844	(1)
Single	5,718	566	566	(1)	1,081	1,081	(1)
$40,000:							
Family of 4	6,312	639	639	(1)	1,188	1,188	(1)
Family of 2	7,052	719	700	$19	1,328	1,328	(1)
Single	8,886	874	700	174	1,653	1,400	$253
$45,000:							
Family of 4	7,737	793	700	93	1,458	1,400	58
Family of 2	8,528	873	700	173	1,606	1,400	206
Single	10,673	1,047	700	347	1,980	1,400	580
$50,000:							
Family of 4	9,323	947	700	247	1,754	1,400	354
Family of 2	10,183	1,027	700	327	1,914	1,400	514
Single	12,559	1,239	700	539	2,326	1,400	926
$120,000[2]	35,578	2,229	700	1,529	5,324	1,400	3,924
$120,000[3]	36,477	3,128	700	2,428	6,223	1,400	4,823

[1] None.
[2] Four person family, all income from wages or salary.
[3] Four person family with $100,000 salary income and $50,000 capital gains (of which only 40 percent or $20,000 is included in income).
Note.—All calculations based on usual assumption of personal deductions equal to 23 percent of income and one wage earner.
Estimated revenue gain: Fiscal year 1982, $6 billion; fiscal year 1983, $13 billion; and fiscal year 1984, 9 billion.

The February 15, 1982 statement by the AFL–CIO Executive Council outlining the program is attached to our testimony. We urge your support.

STATEMENT BY THE AFL–CIO EXECUTIVE COUNCIL ON AN ALTERNATIVE TO REAGANOMICS, BAL HARBOUR, FLA.

The Reagan Administration economic policies, which caused the current recession, must be reversed. This recession has rapidly become the worst since the Great Depression.

The Republican Administration cannot blame anyone else for this recession. The recession was started in July 1981 with Reagan's job-destroying, tight-money, budget-slashing policies. These policies must be stopped. Anti-recession, job-creating programs must be started immediately.

The unfair and excessive tax giveaways of 1981 must be changed to achieve greater equity, pay for the anti-recession program and reduce the runaway Reagan deficits. And the President's second-round budget cuts must be blocked.

The Administration has saddled monetary policy with an unbalanced fiscal policy resulting from President Reagan's huge tax giveaways to the wealthy. This abdication of fiscal responsibility by the Administration places excessive strain on the monetary system and leads to continued high interest rates that further worsen the recession.

The catastrophic economic problems the Administration has created are made even worse by a cruel and regressive ideology which rewards the rich, forgets the jobless, punishes the minorities, ignores the poor and destroys protections for working people, the elderly and the needy.

The President's 1982 State of the Union Message and his Budget Message add up to a total disregard for human needs and for the economic and social costs of high unemployment and recession. Nothing in his proposals will help jobless workers or hasten economic recovery. The President's "new federalism" should not divert public attention from the Administration's blatant failure. The President would thrust basic national responsibilities upon the states, which have historically failed their responsibilities. He would undercut the Constitution and turn America back to the chaos of the Articles of Confederation.

In the year since the Reagan Administration has taken office, adult breadwinners and blacks and other minorities have suffered worse unemployment than anytime since the Great Depression of the 1930s.

Official statistics concede that some 9.3 million men and women are now without jobs. But the true dimensions of the economic crisis are worse than the unemployment statistics.

In addition, another 1.2 million discouraged workers have stopped looking for nonexistent jobs. These "hidden unemployed" don't show up in the government's unemployment rate.

Another 5.4 million workers want full-time jobs but can find only part-time jobs. These men and women and their families are suffering from reduced workweeks and reduced income.

Today America has nearly 16 million men and women who are suffering serious job loss and income loss. The real unemployment rate is 12 percent.

During 1982, one out of every three people in the labor force, more than 30 million Americans, will suffer some unemployment.

President Reagan tells us to wait. The Reagan Administration accepts the recession as unavoidable and engages in wishful thinking that a trickle-down investment boom will develop by itself in this depressed economy, even though the government's own statistics show that the business community has no such plans.

But millions of Americans are suffering and cannot afford to wait. Americans need jobs to put food on the table, pay the mortgage or rent and live in dignity.

Instead of acting to counter the deepening economic decline, the Reagan Administration has cut unemployment insurance benefits, reduced employment and training programs, and welfare assistance at the same time it has destroyed more than one million jobs putting more people on the streets in search of help that's not there. One has to look back 50 years to see such a heartless official reaction to the hardship and suffering of millions of unemployed Americans.

The AFL–CIO calls upon the Congress to reverse these economic policies and set the nation on a path to full employment and balanced economic growth.

OPPOSE BUDGET CUTS

We urge the Congress to reject the newly proposed budget cuts of $41 billion which follow cuts of $33 billion last year. The serious impact of this new budget on workers and the poor is evident in a partial listing:

Job training programs would be slashed even further from last year's cuts.

Trade Adjustment Assistance would be practically eliminated.

Railroad workers' retirement, unemployment and sickness insurance would be eliminated as a separate program.

Medicare benefits for the elderly and severely disabled would be scaled back.

Federal employment would be cut by 75,000 over the next two years.

Federal pay increases would be capped at 5 percent, regardless of comparability with the private sector.

Retirement benefit protections for federal workers would be lowered.

Housing support for low- and middle-income families would be curtailed or eliminated.

Maritime construction support (CDS and Title XI) would be eliminated and operating subsidies (ODS) phased out.

Mass Transit aid would be cut.

Railroad transportation funds (Amtrak) would be reduced.

Educational help to the disadvantaged would be lowered.

Vocational Education support would be trimmed.

Student aid and student loans would be cut back even further than last year.

Economic Development Aid to communities would be terminated.

Sewer and water treatment support would be postponed.

Energy programs would be curtailed.

Energy assistance to low-income families would be cut.

Child nutrition would suffer further cuts.

Welfare and food stamp programs would be sharply curtailed.

Medicaid for the poor would be further reduced.

Day care, foster care, adoption and child welfare would receive less.

RAISE REVENUES

In order to provide the funds for national priorities and basic protections to workers and the poor, as well as to provide funds for new job programs, the AFL–CIO calls upon Congress to undo the worst aspects of last year's tax giveaways to corporations and the wealthy. We also propose the closing of some long-standing tax loopholes. Specific changes in the 1981 tax law should:

Cap the 1982 and 1983 individual tax cuts at $700 per family.

Repeal the leasing of tax credits by corporations.

Repeal the new loopholes in the oil windfall profits tax.

Modify the widened estate and gift tax provisions.

Repeal the future indexing of tax rates.

In addition, Congress should correct these tax loopholes:

Change the foreign tax credit to a tax deduction.

Repeal the foreign tax deferral privileges.

Repeal the tax deferrals of the Domestic International Sales Corporation (DISC).

Repeal the immediate write-off of oil and gas drilling costs and the special depletion allowances.

Reduce the Investment Tax Credit to its former levels.

Apply the lower corporate income tax rates only to corporations with profits of less than $100,000.

Phase out the special capital gains exclusions.

Repeal the special capital gains at death exclusions.

Defense expenditures should be scrutinized carefully, and any increases found necessary should be financed by a separate and equitable surtax on corporations and individuals.

CREATE JOBS

The Congress needs to enact a number of programs to provide jobs, alleviate the suffering of the unemployed, and turn around the worsening recession:

Invest in public infrastructure for the nation's deteriorating communities, including sewer, highway, bridge, mass transit, railroad, and other needed facilities.

Invest in human capital through effective training of the unemployed and provide public employment opportunities for those who still cannot find work after lengthy searches.

Encourage low- and moderate-income housing.

Establish a Reconstruction Finance Corporation to rebuild the nation's industrial base by aiding sectors of the economy and of the country that need special assistance through loans, grants or guarantees.

Limit harmful imports that aggravate the impact of the recession and weaken key industries.

Extend unemployment insurance benefits to protect the long-term jobless.

The Congress should reject the Administration's call for "Enterprise Zones" that would create new sub-classes of citizens and instead, strengthen programs that directly address the problems of unemployment and deteriorating neighborhoods.

The President and the Federal Reserve should exercise their authority to control credit and channel funds to productive purposes, including housing, and to restrict unproductive credit flows for corporate mergers, speculative excesses and foreign investment.

The undue reliance on tight monetary policy, huge budget cuts in social programs, and big tax cuts for the wealthy must be reversed. Tax policy must provide sufficient funds for the nation to fulfill its responsibilities to its citizens, and to provide appropriate balance to the Administration's one-sided monetary economic policy. Budget cuts cannot become an end in themselves—but should be evaluated in terms of justice and need.

The AFL–CIO is convinced that this alternative economic program will put the nation on a path to achieve full employment, stable economic growth, fairness in sharing burdens and a society with compassion for those who have too little.

AFL–CIO Fact Sheet With An Alternative to Reaganomics

The Alternative provides for: increase revenues from undoing the worst aspects of last year's tax giveaways, scrutinizing defense outlays and financing any required increases with a corporate and individual surtax, restoration of newly proposed budget cuts, and establishing new jobs programs. It points out ways to raise additional revenues by closing specific tax loopholes:

Increased revenues

[Anticipated revenues in billions]

Increased revenues from revisions of tax law:	
Cap the 1982 and 1983 individual tax cuts at $700 per family	$20
Repeal the leasing of tax credits by corporations	8
Repeal the new loopholes in the oil windfall profits tax	2
Modify the widened estate and gift tax provisions	1
Repeal the future indexing of tax rates	
Total	31
Increased revenues from savings:	
Scrutinize defense outlays and finance any required increases with a corporate and individual surtax: Current proposed defense budget increase	33
Total of increased revenue and savings	64

Necessary outlays

[Anticipated expenditures in billions]

New jobs programs:	
Invest in public infrastructure for the nation's deteriorating communities, including sewer, highway, bridge, mass transit, railroad, and other needed facilities	$5
Invest in human capital through effective training of the unemployed and provide public employment opportunities for those who still cannot find work after lengthy searches	5
Encourage low- and moderate-income housing	5
Establish a Reconstruction Finance Corporation to rebuild the nation's industrial base by aiding sectors of the economy and of the country that need special assistance through loans, grants or guarantees	4
Limit harmful imports that aggravate the impact of the recession and weaken key industries	

Extend unemployment insurance benefits to protect the long-term jobless	4
Total	23
Restore budget cuts: Restore proposed budget cuts	41
Total new jobs and restoring budget cuts	64

Additional revenues

[Anticipated revenues in billions]

Additional revenue raising proposals achieved by closing specific tax loopholes:	
Change the foreign tax credit to a tax deduction	$10
Repeal the foreign tax deferral privileges	1
Repeal the tax deferrals of the Domestic International Sales Corporation (DISC)	2
Repeal the immediate write-off of oil and gas drilling costs and the special depletion allowances	6
Reduce the Investment Tax Credit to its former levels	7
Apply the lower corporate income tax rates only to corporations with profits of less than $100,000	9
Phase out the special capital gains exclusions	6
Repeal the special capital gains at death exclusions	6
Total additional revenues from closing loopholes	47

Chairman ROSTENKOWSKI. Mr. Rahn, you may proceed.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. RAHN. Thank you, Mr. Chairman. I welcome this opportunity to testify on tax proposals. I am Richard W. Rahn, vice president and chief economist of the Chamber of Commerce of the United States. I am accompanied today by David E. Franasiak, director of the Tax Policy Center, Kenneth D. Simonson, senior tax economist, and Rachelle B. Bernstein, senior tax attorney.

The Chamber remains firmly committed to the administration's four-point economic recovery program of tax cuts, reduction in the growth of Federal spending, regulatory relief, and steady, moderate monetary growth. In particular, we continue to support the principles of the Economic Recovery Tax Act of 1981 and recommend against enactment of any major tax increases. A tax increase would be a grave error. It would stunt economic recovery and fail to solve the deficit problem.

We share the concern that many members of this committee and others have expressed regarding the large deficits forecast for 1983 and beyond. These deficits can and should be reduced. But the proper way to reduce these deficits is through spending cuts, not tax increases.

With Federal outlays now at an all-time high of nearly 24 percent of GNP, Congress can unquestionably make significant reductions in spending. We generally support the administration's spending reduction proposals. Additionally, we suggest further reductions in entitlements and other nondefense spending, a smaller defense increase, and a 1-year freeze on all cost of living adjustments, or COLA's.

The freeze on COLA's alone would save $24 billion. Together, these savings would be large enough to shrink the deficit meaningfully.

The goal of economic policy ought to be to increase per capita incomes for all of our citizens. However, if one looks at history we do not have one case in this country or any other industrialized country where a major peacetime increase led to increased economic growth or an increase in real per capita income. However, we have hundreds of cases where increases in taxes decreased economic growth, led to recessions, depressions and increased the misery of the citizens.

As appendix 1 in our testimony shows, tax increases of the size sought by the administration will cost the economy significant and growing amounts of income, employment and sales. Greater tax increases would have proportionately more damaging effects.

The committee should note that the imminent recovery predicted by virtually all forecasters depends upon the tax cuts becoming effective as legislated. Those who advocate tax rate increases often fail to understand that tax revenues never rise as fast as tax rates. As tax rates go up people choose the leisure of working consumption over savings. The result is less investments, slower productivity growth, more unemployment and lower per capita incomes and a narrower tax base.

Those who advocate tax rate increases in order to cure deficits also frequently fail to understand there is little relationship between tax revenues and deficits. Increases in taxes reduce the number of people who are employed and reduce business profits, thus increasing economic misery.

Government, in order to try to offset this economic misery, increases outlays in the form of food stamps, unemployment compensation, welfare, and so forth. The result is that increasing taxes also causes Government outlays to increase, and hence we are as likely to increase the size of the deficit with a tax increase as to diminish it.

In 1972 the Federal Government tax receipts were $207 billion. This year they are projected to be approximately $630 billion. Despite this threefold increase in tax revenues, the deficits have gone up rather than down. The problem is not one of insufficient tax revenues. The problem is one of excessive Government spending.

Federal spending has been growing rapidly as a share of GNP. If the Congress really desires to reduce the size of the deficit the way to do it is to reduce Federal spending as a percentage of GNP over the next several years. If Congress follows that course of action, the deficits in real terms will diminish and our deficit problem will disappear.

There is one additional myth which should be laid to rest: That is the myth that the deficits are the cause of high interest rates. There is no evidence to support that proposition. The Japanese and Germans, for instance, are running deficits that are far higher as a percentage of their GNP than we are. Yet, for instance, the Japanese now have an inflation rate of about 3 percent and a prime rate of slightly over 6 percent. In 1976 our deficit was a larger share than it is projected to be this year, yet interest rates and inflation fell and an economic recovery took place.

The primary reason interest rates are so high is, first of all, highly erratic monetary growth rates. The Federal Reserve has failed to insure that money grows at a slow and steady rate. Its

highly erratic behavior has caused much uncertainty in financial markets. In addition, as a result of the enormous tax and spending policy uncertainty, financial markets have added an additional risk premium which has driven up interest rates.

Finally, there is indeed psychological fear about the size of the deficit. The deficit ought to be brought down, but the proper way to bring down the deficit is through spending reduction, not tax increases.

Fifty years ago this Nation was faced with a similar problem. The economy was in a slump and the deficit was growing. The Hoover administration and the Congress agreed to raise taxes by $900 million or nearly 30 percent of the 1931 level. However, receipts actually fell by $1.2 billion in 1932. The deficit was widened from $0.5 billion to $2.7 billion and a severe recession turned into the Great Depression. Let us not repeat that mistake.

In addition to the reasons I have given to you for not increasing taxes, we know that constant modification of the Tax Code leads to greater business uncertainty and thus hampers corporate investment by raising risk premiums. Stability in the tax system is essential to the goal of stimulating the economy through business expansion.

Also, the public opposes tax increases. In the latest U.S. Chamber/Gallup consumer opinion survey only 4 percent favored tax increases alone and only 21 percent favored a combination of tax increases and spending cuts to lower the deficit. However, more than twice as many respondents preferred reducing spending alone. The poll also showed better than 2-to-1 support for spending cuts and a strong opposition to a variety of consumer taxes.

In conclusion, the U.S. Chamber opposes any delay of the already-legislated individual rate cuts and indexing of the tax system. We oppose the proposals for repeal of safe-harbor leasing and the addition of a new alternative corporate minimum tax, proposals for acceleration of corporate payments, and interest and dividend withholding.

A tax increase now would be unpopular with the American people, would retard economic growth, and add to the Nation's misery. It is unlikely to narrow the deficit appreciably—if at all—and even if it did there is no evidence it would lower interest rates.

We urge the Congress to allow the economic recovery program which you overwhelmingly supported less than a year ago to work. Do not take back the individual and business tax cuts before they can operate to rejuvenate our economy.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF DR. RICHARD W. RAHN FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. Chairman, I welcome this opportunity to testify on tax proposals. I am Richard W. Rahn, Vice President and Chief Economist of the Chamber of Commerce of the United States, the world's largest business federation, representing over 230,000 businesses, chambers and associations. I am accompanied by David E. Franasiak, Director of the Tax Policy Center, Kenneth D. Simonson, Senior Tax Economist, and Rachelle B. Bernstein, Senior Tax Attorney.

SUMMARY

The Chamber remains firmly committed to the Administration's four-point economic recovery program of tax cuts, reduction in the growth of federal spending, regulatory relief, and steady, moderate monetary growth. In particular, we continue to support the principles of the Economic Recovery Tax Act of 1981 and recommend against enactment of any major tax increases. A tax increase would be a grave error. It would stunt economic recovery and fail to solve the deficit problem.

We share the concern that many members of this Committee and others have expressed regarding the large deficits forecast for 1983 and beyond. These deficits can and should be reduced. But the proper way to reduce these deficits is through spending cuts, not tax increases.

With federal outlays now at an all-time high of nearly 24 percent of GNP, Congress can unquestionably make significant reductions in spending. We generally support the Administration's spending reduction proposals. Additionally, we suggest:

Further reductions in entitlements and other non-defense spending,

A smaller defense increase, and

A one-year freeze on all cost of living adjustments (COLA).

The freeze on COLAs alone would save $24 billion. Together, these savings would be large enough to shrink the deficit meaningfully.

CUT SPENDING; DO NOT INCREASE TAXES

The public is concerned about deficits. In response, some members of the Administration, the Congress and even the private sector have begun to advocate tax increases. We agree that the deficit is a problem. However, enactment of a major tax increase would be a grave mistake which would jeopardize the well-being of our citizenry. The Economic Recovery Tax Act of 1981 (ERTA) is the cornerstone of a comprehensive set of policies to revitalize the economy and ensure stable growth in the standard of living. Over the past several years the Chamber has encouraged policies to enhance productivity growth, boost savings and investment, and improve our competitiveness in world markets. Last year, the President proposed, and Congress enacted, a series of bold tax cuts to achieve these goals.

The need for a positive economic program is even more pressing today than it was a year ago, and the problem is now compounded by a recession that spread faster and further than anyone anticipated a few months ago.

Under these circumstances, it is counterproductive to enact tax increases or delay the already enacted tax cuts. Tax increases reduce consumer spending power and individual saving, and businesses' ability to invest, thus slowing private economic activity and raising unemployment. As Appendix 1 shows, tax increases of the size sought by the Administration will cost the economy significant and growing amounts of income, employment and sales. Greater tax increases would have proportionally more damaging effects. The Committee should note that the imminent recovery predicted by virtually all forecasters depends on the tax cuts becoming effective as legislated.

As we perceive it, the public is most concerned about the lack of economic growth, high unemployment, and high interest rates, and not about deficits directly. Deficit reduction is important only insofar as it contributes to curing the primary problems. But tax increases now would crimp expansion, discourage employment, and reduce the supply of lendable funds, driving up interest rates, while doing little or nothing to bring down the deficit. That is why the deficit must be narrowed by reducing federal spending. Spending reduction is far more likely to aid recovery by returning more resources to private hands. To the extent the spending cutbacks involve federal lending and loan-guarantee programs, they reduce federal competition with private borrowers, helping to bring down interest rates.

Concern for deficits, while clearly justified, can be misguided when not related to the primary objective of the Program for Economic Recovery—reducing the share of national income that accrues to government. This share has reached record levels. Lowering it should be the major goal of public policymakers. Debate over the source of this share—taxes or borrowing—distracts from our primary objective of reducing government spending and may even preclude our ever attaining it.

The deficit is a symptom of deeper problems. The current deficit is a result of excessive federal spending over the past twenty years. The Congress has failed to come to grips with entitlement programs that continue to grow at rates in excess of the Nation's ability to finance both them and other urgent national objectives. In effect, a tax increase this year would be an acknowledgement of our failure to control spending.

We at the Chamber find proposals to increase taxes to be dangerously premature. A large deficit provides a reluctant Congress with a powerful incentive to cut spending growth. Raising taxes diminishes this incentive and reduces the sense of fiscal urgency required to make the tough choices on budget priorities.

Tax revenues never rise as fast as tax rates. When tax rates go up, either explicitly or through changes in other provisions which push people into higher brackets, taxpayers receive a smaller after-tax return on their labor or investments. The incentive to choose leisure or nonmarket activities over taxable effort is enhanced. As a result, the amount of each activity that they undertake is reduced. The reduced economic activity not only costs the government revenues, it adds to the demand for outlays such as income maintenance programs. Hence a tax rate increase may be self-defeating in terms of deficit reduction.

History of tax rate changes.—The history of tax rate changes in this country and abroad makes this point forcefully. To cite just a few examples: Rate reductions in the U. S. in the 1920s, 1946, 1948, 1964-65, and 1978 (for capital gains) all led to dramatic growth in revenues. Conversely, rate increases in 1916-20, 1932, and 1968-69 were quickly followed by sharp drops in reported income, tax collections, and economic activity. Rate reductions in Germany in 1948, Japan in 1950, and Puerto Rico in 1977-79 were followed by steep upturns in economic growth and tax receipts.

The most egregious instance, which is somewhat similar to today's circumstances, occurred in 1932. Then, as today, the economy was in a slump and the deficit was growing. The Hoover Administration and Congress agreed to raise taxes by $900 million, or nearly 30 percent of the 1931 level. However, receipts actually fell by $1.2 billion in 1932, the deficit widened from $0.5 billion to $2.7 billion, and a severe recession turned into the great depression.

Rate changes have a proven effect on personal savings rates. From 1963 to 1965, when tax rates were reduced an average of 19 percent, the personal savings rate rose 31 percent. It continued to rise through 1967, for a total gain of 50 percent in 4 years. Then a 10 percent tax surcharge was imposed in 1968 and 1969, and the savings rate dropped by 21 percent. When the surcharge was removed in 1970 and 1971, the savings rate climbed 26 percent. Each time, the savings rate changed by 2 to 3 times as much as the tax rate change. Such a savings rate change in response to the rate cuts enacted last year would lead to an increase in savings of roughly $100 billion by 1984.

Business uncertainty.—Constant modification of the tax code leads to greater business uncertainty and hampers corporate investment by raising risk premiums. Stability in the tax system is essential to the goal of stimulating the economy through business expansion. However, businesses cannot make investment decisions when tax policy changes from day to day. ERTA was aimed at stimulating capital investment by providing for accelerated depreciation, larger investment tax credits, and safe-harbor leasing. When proposals are made to repeal a major portion of these tax incentives within six months after the enactment of that bill, businesses will not make a decision to invest that may be at all dependent on these incentives.

Public opposes tax increases.—The public opposes tax increases. In the latest U.S. Chamber-Gallup Consumer Opinion Survey, conducted in December, only 4 percent favored tax increases alone, and only 21 percent favored a combination of tax increases and spending cuts to lower the deficit. More than twice as many respondents preferred reducing spending alone. That poll also showed better than 2-1 support for more spending cuts, and strong opposition to a variety of consumer tax increases. (See Appendix 2 for full text of questions and responses.) Other recent polls find the same attitudes prevail.

In sum, a tax increase now will be unpopular and will retard economic growth. It is unlikely to narrow the deficit appreciably, and even if it does, such a result is irrelevant to lowering interest rates or improving economic well being. There is no good rationale for a tax increase.

Individual income tax.—Among the most frequently suggested tax increases here on Capitol Hill is the delay of the individual rate cuts. The three-year individual rate cuts are the backbone of the individual relief under ERTA. As enacted, they are already scaled back in time and amount from the President's original proposal for 10 percent cuts in 1981, 1982, and 1983. The enacted cuts are barely sufficient to keep most taxpayers whole, even given the recent lessening of inflation. Furthermore, the vast majority of businesses, including a large portion of the U.S. Chamber's 230,000 members, consists of unincorporated businesses that report their business incomes as individual taxpayers. Thus, any delay would push both personal and business tax burdens above their record high levels and would seriously undermine ERTA's incentives for individual work, saving and investment.

Corporate tax.—The media has projected the perception on Capitol Hill and around the country that corporations no longer pay any income taxes. In response to this perception, legislators have proposed the repeal of safe-harbor leasing and the adoption of an alternative minimum tax.

The corporate income tax is not dead. The Administration's 1983 Budget figures show that after a one-year drop in receipts from $61 billion in fiscal 1981 to $47 billion this year (due as much to the recession as to ERTA), corporate tax receipts are projected to climb rapidly to $65 billion in 1983, $84 billion in 1984, and $88 billion in 1985. In fact, between 1982 and 1984, the corporate share of total receipts would grow from 7.5 to 11.6 percent, while every other revenue source remains virtually steady or declines as a share of total receipts. To quote Samuel Clemens: "The reports of my death are greatly exaggerated."

In considering corporate tax changes, Congress should also bear in mind that corporate taxes are actually paid by individuals—consumers, employees, shareholders, pensioners. The corporation acts only as tax collector for the government. If the corporate income tax is increased, companies will pass on the burden to customers by raising prices; to workers by laying off staff, shortening hours, or reducing wage and benefit increases; and to shareholders by realizing lower profits, thus discouraging them from investing. Retirees can lose in all three capacities, facing higher consumer prices, smaller pension fund contributions by the companies, and slower growth or reduction in dividends and stock prices whether owned directly or through their pension fund. The relative effect varies from one firm to another, but in all cases it is individuals who suffer, not companies.

Safe-harbor leasing.—Safe-harbor leasing is an important part of the Accelerated Cost Recovery System (ACRS) enacted in ERTA. It spreads the benefits by allowing economically sound companies with temporary losses to utilize ACRS fully, and in this way facilitates increased investment in new plant and equipment. If the Congress believes that there are abuses in the use of these provisions, it should be certain to define the abuses correctly and modify the safe-harbor leasing rules accordingly. Leasing is designed to stimulate the economy by encouraging capital investment and should not be repealed solely because of "bad public perceptions".

Moreover, the Chamber supports the expansion of the safe harbor leasing provisions to allow closely held businesses to participate as lessors without the application of the "at-risk" rules contained in Section 465 of the Internal Revenue Code. Under the present rules, small businesses in which 50 percent or more of the value of the outstanding stock is owned directly or indirectly by not more than five individuals are effectively denied the opportunity to participate as lessors.

Safe-harbor leasing helps assure that the entire economy will be stimulated without encouraging unsound investments made strictly as tax shelters, and it substantially reduces the complexity and uncertainty under the old leasing rules. For these reasons, we oppose repeal of the leasing provisions and support changes to allow full participation by small businesses.

Minimum tax.—There is no adequate economic or tax policy rationale for enacting the alternative corporate minimum tax. It is not responsive to criticisms that corporations pay no taxes, and it does little to close the budget deficit while causing great distortions in investment activity.

Moreover, a minimum tax is counterproductive and hypocritical because it subjects to taxation certain business deductions properly taken from income as a result of Congressional desire to create incentives for certain types of economic behavior. If such incentives are no longer needed, these provisions should be repealed or modified directly, rather than by enacting an alternative minimum tax which adds more complexity to an already complex tax code. We believe that the reason repeal of these incentives has not been requested is because they are necessary in order to make the economic recovery program work properly.

The Treasury's minimum tax proposal particularly undermines ACRS. Under the proposal, the investment tax credit could not be used to reduce the minimum tax due. Accelerated depreciation and larger investment tax credits were enacted to encourage capital investment. Disallowing the application of the investment tax credit to the corporate minimum tax would greatly weaken the investment incentive which last summer Congress agreed was so desperately needed to stimulate economic recovery. That need is still present today. In circumstances where a company would be subject to the minimum tax for a period of years, the benefit conferred by the investment tax credit may in certain cases be reduced from 90 percent to as little as 67 percent of regular tax liability. Disallowing the application of the investment tax credit to the alternative minimum tax accounts for 45 percent of the revenue to be gained by enacting this proposal. Hence, the alternative minimum tax is not a proposal to make sure that corporations which have deductions arising from

too many "tax preferences" pay some tax, but rather it is a proposal to repeal the basic incentives for capital investment which were enacted last summer.

Another problem with the minimum tax proposal is that net operating loss carryovers may not be considered in computing the alternative minimum tax base. The impact of the tax can be particularly onerous for firms or industries recovering from a period of economic distress and firms attempting to accelerate growth with heavy investments in research or capital assets.

The minimum tax would also cause great complexity in business planning. Under the alternative minimum tax, corporations which have tax deductions resulting from a variety of different operations covered by the tax preference items would be subject to the minimum tax. Other corporations which have even more deductions to offset income may not be subject to the minimum tax if these deductions are not in the tax preference areas. Thus, the capricious selection of certain corporate tax deductions as tax preference items results in discrimination between taxpayers.

We strongly oppose any substantive changes in the treatment of the foreign tax credit as it relates to the corporate minimum tax. The credit operates to prevent double taxation of foreign earnings. A denial of credit for taxes previously paid abroad would be inequitable to those corporations with foreign operations. Without such credits, operating costs are increased and competitiveness is lowered.

Accelerated corporate tax payment.—The proposal to increase federal revenues by an acceleration of corporate payments would increase tax burdens for thousands of companies while providing only a one-shot benefit to the Treasury. Although the proposal would require companies to make estimated payments of only 90 % of the tax due, many firms say they would in effect be forced to overpay their taxes to be sure of avoiding the penalty for underpayment. An increase in the penalty provisions for underpayment of taxes exacerbates this problem. ERTA changed the interest rate penalty from 12% to the prime rate in effect the prior September, which means the rate is now 20%. The speed-up particularly impacts firms in cyclical industries and others with fluctuating income because these companies cannot rely on prior year's earnings to estimate current liability accurately.

Dividend and interest withholding.—We oppose the Administration's plan to require five percent withholding on dividends and interest. This plan would result in heavy compliance costs for hard-pressed financial institutions and other payors, and in over-withholding from many law-abiding taxpayers, while failing to effectively stop tax evasion. There are other steps Congress and the IRS should examine short of imposing these costly and unjust burdens.

IRS personnel increase.—The Chamber supports the proposal to add 5,225 more staff members to the Internal Revenue Service, provided the additional personnel are used to maximize compliance and reduce tax evasion rather than to add to the burdens of the overwhelming majority of taxpayers who are law-abiding. The IRS has been given tasks of steadily increasing complexity, without the added personnel to match. Meanwhile, the perception of spreading tax evasion has grown. These new personnel, wisely used, can increase both compliance and public confidence in the tax system. Higher collections from existing law reduce the impetus to impose burdensome new taxes.

CONCLUSION

We continue to support President Reagan's four-point economic recovery program because it offers a complete formula for long-term economic growth. The deficit problem must be addressed by slowing the growth in government programs, not through increased taxes. Higher taxes do not guarantee a balanced budget, only slower economic growth, less employment, and chronic stagflation. An increase in

APPENDIX 1.—ECONOMIC EFFECTS OF TAX INCREASES, 1983–86

	1983	1984	1985	1986
GNP (billions)	−$3.7	−$15.3	−$37.2	−$68.2
After-tax corporate profits (billions)	−$13.3	−$20.6	−$23.7	−$28.9
Employment (millions)	0	−.1	−.3	−.5
New car sales (millions)	0	−.2	−.4	−.7

Source: U.S. Chamber of Commerce, Forecast Center. Assumes tax increases as listed in the administration's 1983 budget proposal: $12.7 billion in fiscal 1983, $19 billion in fiscal 1984, $18.2 billion in fiscal 1985, and $17.7 billion in fiscal 1986.

taxes at this time will only relieve the pressure for further budget cuts and hamper the economic recovery. We urge Congress to allow the economic recovery program, which you overwhelmingly supported less than a year ago, to work. Do not take back the individual and business tax cuts before they can operate to rejuvenate our economy.

APPENDIX 2.—CONSUMER ATTITUDES TOWARD SPENDING CUTS AND TAX INCREASES

In January, additional reductions in government spending may be proposed in order to reduce the size of the federal government deficit and move closer to a balanced budget. Would you strongly favor, somewhat favor, somewhat oppose, or strongly oppose making additional reductions in federal government spending?

	Percent
Strongly favor	31
Somewhat favor	28
Somewhat oppose	14
Strongly oppose	12
Don't know	15

If you had to choose, which of the following would you prefer to do in order to reduce the size of the federal deficit: reduce federal government spending, increase federal taxes, or would you prefer to both reduce federal spending and increase federal taxes?

	Percent
Reduce Federal spending	54
Increase Federal taxes	4
Both reduce spending and increase taxes	21
Neither (volunteered)	8
Don't know	13

Last summer, income tax rates were cut by 25 percent, and scheduled to go into effect in three stages as shown on this card. Recently, some people have proposed that the tax cuts scheduled for July 1982 and July 1983 both be postponed six months in order to reduce the deficit in the federal budget. Other people have proposed that these two tax cuts both be put into effect six months earlier, or postponing them by six months, or letting them go into effect in July 1982 and July 1983 as scheduled?

	Percent
Start 6 mos earlier	30
Postpone 6 mos	21
Start as scheduled	29
No tax cut (volunteered)	3
Don't know	17

Another proposal is to eliminate the federal income tax deduction for interest paid on consumer loans, except that interest paid on a loan to buy an automobile would still be deductible. Would you favor or oppose eliminating the federal income tax deduction for interest on consumer loans, except for interest on automobile loans?

	Percent
Favor elimination	28
Oppose elimination	52
Don't know	20

Source: U.S. Chamber-Gallup Consumer Opinion Survey.

The survey involved 1,480 face-to-face interviews by The Gallup Organization with a representative sample of the U.S. public, 18 years and older conducted between December 11-14, 1981. It is very probable (95 chances out of 100) that the survey findings are within three percentage points of the figures that would have been obtained if the entire adult population had been interviewed.

Chairman ROSTENKOWSKI. Mr. Huard, you may proceed.

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT FOR TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman. My name is Paul Huard. I am vice president for taxation and fiscal policy of the National Association of Manufacturers. I am accompanied this morning by Mr. David H. Miller, associate director of taxation.

Chairman ROSTENKOWSKI. Would you speak a little louder, please?

Mr. HUARD. Yes. NAM represents nearly 12,000 member firms who account for nearly 80 percent of the Nation's industrial output and 85 percent of the Nation's industrial work force. We are grateful for the opportunity to present the association's views on the administration's tax proposals.

At the outset, I would like to note that NAM has consistently supported the President's program for economic recovery. This four-point program, as announced last year, calls for substantial reductions in the growth of Federal spending, major cuts in the taxation of both businesses and individuals, moderation and stability in the growth of the money supply, and regulatory reform to alleviate excessive Government regulation.

We believe this program, if consistently pursued, will provide the climate we need for meaningful improvements in productivity and sustained economic growth. NAM continues to support all four points of this program as a package. We therefore oppose any retrenchment in the tax reduction component of that program, particularly when that retrenchment would impact so disproportionately on the business sector.

Overall, we continue to believe that the administration's program for economic recovery offers excellent prospects for generating higher rates of both capital investment and productivity growth through the mid-1980's and beyond.

These prospects, however, will be substantially diminished if the Congress enacts major increases in business taxes. Moreover, the current state of the economy, which is now in a fairly serious recession, further underscores the need for retaining the business tax cuts enacted last year. In this regard there are a number of factors to be considered.

Business liquidity, now at its lowest point since World War II, has been depressed by both the decrease in sales resulting from the current recession and the heavy dependence on short-term borrowing at high interest rates to meet working capital requirements. This in turn has compounded the longer-term trend toward decreased capital formation that was in evidence in the late 1970's.

Moreover, while recovery from the current recession can be expected to begin in the next several months, there is a good chance that it will be somewhat weaker than the average postwar recovery, particularly with regard to durable goods and capital intensive industries.

Given the foregoing, NAM believes it is essential to retain the tax cuts enacted in the Economic Recovery Tax Act of 1981. Such retention will increase business cash flow, with the resulting improvement in liquidity leading to greater reliance on retained earn-

ings as a source of working capital. The corresponding decrease in reliance on short-term borrowing will improve debt/equity ratios and ultimately will yield higher capital spending rates.

On the other hand, raising business taxes at this time would entail a serious risk of prolonging the current recession and/or weakening the subsequent recovery.

Given this backdrop, we are frankly distressed at the apparent haste with which some seem to be willing, in effect, to dismantle the business tax cuts that were so recently enacted. Indeed, there seems to be altogether too little awareness of the fact that under the first 5 years of the Economic Recovery Tax Act only 20 percent of the tax cuts are directed to the business sector. The remaining 80 percent, some $600 million, goes to individual taxpayers.

In light of the business sector's share of the Economic Recovery Tax Act cuts, which share is significantly smaller proportionately than in any other major tax cut bill enacted in the last several decades, we are greatly concerned over the amount of money the administration would withdraw through its proposed tax changes.

This is particularly disturbing when viewed over the next 2 fiscal years, when recovery from the current recession is crucial. Over fiscal year 1983–84, the administration's tax increases would amount to 56 percent of the total benefit to be received by business under the Economic Recovery Tax Act over the same period.

If noncorporate taxpayers, for example, sole proprietors, are factored out, the fiscal year 1983–84 increase in corporate taxation under the administration's proposals equals about 73 percent of the Economic Recovery Tax Act tax cuts over that period. Under the circumstances we cannot help but view these proposals as being adverse to both the specific goal of capital recovery and the general goal of economic recovery.

My full statement, submitted for the record, details our position on several major elements of the administration's tax proposal. In the interest of time, however, I will confine myself to summarizing our overall position on tax legislation at this time.

NAM opposes any general tax increase on either businesses or individuals at this time. The tax component of the President's program for economic recovery is premised upon substantial reductions in the burden of taxation and must be given time to work.

Tax increases should be approached, if at all, only with great caution. The historic tax legislation passed in 1981 was a long overdue step toward reducing the bias in our tax system against savings and investment. NAM, therefore, opposes any tax revisions which would substantially impair liquidity and capital formation. In this category, we would include the proposals to expand the corporate minimum tax, to eliminate the completed contract method of accounting, to speed up corporate tax payments, and to repeal or restrict the safe-harbor leasing rules. In the latter case we recognize this has not been suggested by the administration. However, there have been so many bills introduced in the House and Senate to do just that, that we feel it is appropriate to comment.

Further cuts in Federal spending, not tax increases, are, together with moderation in the growth of the money supply, the key to reducing budget deficits, lowering interest rates, and achieving a healthy economic recovery. No part of the Federal Government, in-

cluding defense, social security, and entitlement programs, should be exempted from the budget-cutting process.

That concludes my remarks, Mr. Chairman. Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL R. HUARD ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

My name is Paul R. Huard. I am Vice President of the Taxation and Fiscal Policy Department of the National Association of Manufacturers. NAM represents nearly 12,000 member firms who account for nearly 80% of the nation's industrial output and 85% of the nation's industrial workforce. I am pleased to be here to present the Association's views on the Administration's tax proposals.

Our comments regarding the need for tax increases in order to reduce federal deficits are summarized below:

SUMMARY

NAM opposes any general tax increase on either business or individuals at this time. The tax component of the President's Program for Economic Recovery is premised upon substantial reductions in the burden of taxation and must be given time to work.

Tax increases should be approached, if at all, only with great caution. The historic tax legislation passed in 1981 was a long overdue step towards reducing the bias in our tax system against savings and investment. NAM therefore opposes any tax revisions which would substantially impair liquidity and capital formation. In this category we would include proposals to expand the corporate minimum tax, eliminate the completed contract method of accounting and repeal or restrict the "safe harbor" leasing rules.

Further cuts in federal spending—not tax increases—are, together with moderation in the growth of the money supply, the key to reducing budget deficits, lowering interest rates and achieving a healthy economic recovery. No part of the federal budget—including defense, Social Security and entitlement programs—should be exempted from the budget cutting process.

SUPPORT OF PRESIDENT'S PROGRAM

NAM strongly supports the President's Program for Economic Recovery. This four-point program, as announced last year, calls for:

Substantial reductions in the growth of federal spending;

Major cuts in the taxation of both business and individuals;

Moderation and stability in the growth of the money supply; and

Regulatory reform to alleviate excessive government regulation.

We believe this program, if consistently pursued, will provide the climate we need for meaningful improvements in productivity and sustained economic growth. NAM continues to support all four points of this program as a package. We therefore oppose any retrenchment in the tax reduction component of that program, particularly when that retrenchment would impact so disproportionately on the business sector.

BUSINESS TAX CUTS SHOULD NOT BE CURTAILED

Overall, we continue to believe that the Administration's Program for Economic Recovery offers excellent prospects for generating higher rates of both capital investment and productivity growth throughout the mid-1980s and beyond. These prospects will be substantially diminished if the Congress enacts major increases in business taxes. Moreover, the current state of the economy, which is now in a fairly serious recession, further underscores the need for retaining the business tax cuts enacted last year. In this regard, there are a number of factors to be considered.

Business liquidity—now at its lowest point since the end of World War II—has been depressed by both the decrease in sales resulting from the current recession and the heavy dependence on short term borrowing at high interest rates to meet working capital requirements. This in turn has compounded a longer term trend toward decreased capital formation that was in evidence throughout the late 1970s.

Moreover, while the recovery from the current recession can be expected to begin in the next several months, there is a good chance that it will be somewhat weaker than the average postwar recovery, particularly with regard to durable goods and capital intensive industries.

Given the foregoing, NAM believes it essential to retain the tax cuts enacted in the Economic Recovery Tax Act of 1981 (ERTA). Such retention will increase business cash flow, with the resulting improvement in liquidity leading to greater reliance on retained earnings as a source of working capital. The corresponding decrease in reliance on short term borrowing will improve debt-equity ratios and ultimately will yield higher capital spending rates.

On the other hand, raising business taxes at this time would entail a serious risk of throwing the economy into deeper recession. Tax increases would further reduce business cash flow, forcing companies to increase their reliance on short term debt at a time when they are already highly leveraged and suffering the effects of high interest rates. If the problem of business illiquidity is so compounded, existing productive capacity will continue to be underutilized and there will be less new capital investment. Accordingly, the current recession might be prolonged even further and, when it comes, the recovery might be even more sluggish than anticipated. In short, a major purpose of ERTA—the stimulation of a healthy, prolonged economic recovery—might well be aborted.

Given this backdrop, we are frankly distressed at the apparent haste with which some seem to be willing, in effect, to dismantle the business tax cuts that were so recently enacted. Indeed, there seems to be altogether too little public awareness of the fact that, under the first five years of ERTA, only 20% of the tax cuts are directed to the business sector. The remaining 80%—some $600 billion—goes to individual taxpayers. In light of the business sector's share of the ERTA tax cuts—which share is significantly smaller proportionately than in any other major tax cut bill enacted in the last several decades—we are greatly concerned over the amount of money the Administration would withdraw from business cash flow through its proposed tax changes.

The figures are particularly disturbing when viewed over the next two fiscal years, when a healthy recovery from the current recession is crucial. Over FY83-84, the Administration's tax increases would amount to 56% of the total benefit to be received by business under ERTA over the same period. If noncorporate taxpayers (e.g., sole proprietors) are factored out, the FY83-84 increase in corporate taxation under the Administration's proposals equals about 73% of ERTA corporate tax cuts over that period. Under the circumstances, we cannot help but view these proposals as being adverse to both the specific goal of capital formation and the general goal of economic recovery.

I will now comment briefly on a number of specific areas of concern.

CORPORATE MINIMUM TAX SHOULD NOT BE EXPANDED

NAM strongly opposes any expansion of the corporate minimum tax. A number of the reasons for our position have already been discussed, e.g., the adverse impact on business liquidity and the dilution of the business sector's ERTA tax cuts. In addition to those general concerns, we fear specifically that the proposed expansion of the corporate minimum tax would impact very adversely on the availability and effectiveness of the investment tax credit (ITC) as a stimulant to investment in new productive plant and equipment. Indeed, under the Administration's proposal, a company with no so-called preferences but which, due to a combination of Accelerated Cost Recovery System (ACRS) deductions and the ITC, has an effective tax rate under 15%, would see part or all of those deductions and credits nullified.

Both in such cases as well as in cases where the minimum tax is triggered due to utilization of preference items (for instance DISC) that were intended to further a specific Congressional goal (e.g., stimulation of exports, in the case of DISC), we think it is both counterproductive and unfair to penalize a taxpayer for acting efficiently in a manner which the Congress saw fit to encourage.

NAM also is concerned that, in addition to posing a significant disincentive to capital investment and, therefore, to the creation of new jobs, the proposed new corporate minimum tax would have a very uneven impact. In particular, due to the extent to which net operating losses would be disregarded, it would have a disproportionate effect on companies just returning from loss positions to positions of marginal profitability.

Finally, we think that by instituting what amounts to a permanent two-track system of computing corporate income tax liability, this proposal would add greatly to the complexity of the tax laws.

For all of these reasons, we vigorously oppose any expansion of the corporate minimum tax.

COMPLETED CONTRACT METHOD SHOULD BE RETAINED

NAM believes that the tax laws should continue to recognize that the completed contract method of accounting is the most appropriate method for taxpayers in the construction, shipbuilding and electronics, aerospace and other industries where the contracts involve significant uncertainties regarding profit and loss which are generally not resolved until the completion of the contract. The tax laws should also continue to allow taxpayers utilizing the completed contract method of accounting to deduct, in the year incurred, expenses that historically have been allowed as period costs. Tax policy has long treated advance payments on long term contracts as financing mechanisms and the NAM sees no justification for reversing this long established policy.

The completed contract method responds to problems created by the nature of the long term contractor's business. Unlike a typical manufacturer, a taxpayer using a long term contract method of accounting obtains contracts by bidding or negotiating for specific projects or manufacturing an item that takes more than twelve months to complete. Generally, the original contract price is based on an estimate of the costs to complete the contract. Consequently the contractor may be exposed to risks associated with the reliability of the estimates over the period of time it takes to complete the project. The severity of this risk is determined by many variables outside the control of the contractor, such as strikes, weather, inflation, availability of materials and development of technology. This inherent risk of projecting costs distinguishes the long term contractor from other taxpayers. Sound tax policy therefore requires that taxpayers be permitted to defer revenue and expenses on contracts until they are complete and the income or loss is determined with reasonable certainty.

Moreover, we are concerned that repeal or substantial modification of the completed contract method will have an adverse impact on the United States defense industrial base at a time when the Administration has proposed a substantial increase in defense preparedness. Repeal or substantial modification of the completed contract method as a financing device would require the defense industry to go to the financial markets for large amounts of new capital. Some companies, particularly small and medium-sized firms, might not be able to attract the necessary capital and therefore might be forced into bankruptcies or unwise mergers. Those companies able to survive probably would have to borrow funds at high interest rates. This additional cost would raise the defense contractor's overall cost of doing business, which would of necessity increase the cost of weapons systems procurement by the Department of Defense. In effect, the Treasury's gain would be largely illusory, since it would be offset by the Defense Department's increased procurement costs.

Repeal or substantial modification of the completed contract method of accounting also would have a disastrous impact on the already hard hit construction industry which, like the defense industry, has long utilized this method. Construction contractors need large sums of money to operate and expand. As an industry they are particularly vulnerable to strikes, weather and inflated prices for materials and other factors beyond their control. Retention of funds by developers until the project is complete further complicates the ability of construction contractors to compute their profit with a fair degree of reliability. However, to pay taxes on moneys received in connection with unfinished projects would limit the size of the project the contractor could bid on and would eliminate a badly-needed source of financing.

Finally, NAM believes that taxpayers utilizing the completed contract method of accounting should be allowed to deduct, in the year incurred, expenses that historically have been allowed as period costs. Period costs are those costs deductible in the year paid or incurred regardless of when income is recognized and are so deducted because they benefit the taxpayer's business as a whole, whereas contract costs or absorbed costs must be deducted at the conclusion of the contract.

Period costs, instead of adding value to the item under contract, represent costs incurred to benefit the operations of the taxpayer as a whole for a particular period or costs that have been made deductible in a certain way to provide an incentive to the taxpayer. On this latter point, for example, it would be particularly inconsistent for the Congress to enact a system allowing the accelerated recovery of capital costs in one year and in the next year to disallow a current deduction for the accelerated portion of the recovery, as would occur under the Administration's proposed treatment of period costs.

Accordingly, it is NAM's position that the accounting methods now applicable to long term contractors, including the treatment of period costs, should be retained in their present form. Where, however, the Administration believes it has identified a particular area of abuse, for instance with regard to multi-unit contracts spanning a

decade or more, we would not oppose appropriate corrective action by Treasury regulation.

SAFE HARBOR LEASING SHOULD BE RETAINED

While the Administration has not proposed to modify or repeal the ERTA rules on safe harbor leasing, many bills to do just that have been introduced in both the House and the Senate. Therefore, we believe a brief comment on the leasing rules is appropriate.

NAM fully supports the Administration's view that the safe harbor leasing rules are an integral and necessary part of ACRS. The principal purpose of such rules is to stimulate investment in new plant and equipment by temporarily unprofitable companies. These rules achieve just that by making the cash flow benefits of ACRS and the ITC immediately available to such companies.

By so doing, the leasing rules remove what would otherwise be a substantial disincentive to new investment. These rules also promote tax neutrality by equalizing the costs of investment as between profitable and unprofitable companies.

Also, it should be noted that many leasing transactions now taking place would probably have taken place anyway even under the more restrictive pre-ERTA leasing rules. We think it is highly significant that, under the new safe harbor leasing rules, more of the cash flow benefits of ACRS and the ITC pass to the company utilizing the equipment than would have under the old rules. In other words, the new leasing rules work better and more efficiently than the old rules. We believe they should be retained. Such abuses, if any, as have been clearly indentified can be addressed by appropriate modification.

CONCLUSION

In conclusion, NAM opposes any major increase in business taxation, since such tax increases would impair capital formation and slow the economic recovery. In this regard, we should mention also our opposition to the Administration's proposal to speed up corporate estimated income tax payments. While not a tax increase as such, the cash flow loss due to the timing difference has the same net effect as a business tax increase and is particularly inadvisable in this time of general business illiquidity.

NAM strongly urges this Committee to limit any changes in the tax laws to improvements in compliance and enforcement, and the elimination of provisions that are demonstrably duplicative or excessive. Instead of any major increase in the taxation of either business or individuals, we urge the members of this Committee, in their capacity as members of this and other Committees of the Senate, to address the real problem by enacting further major reductions in all areas of government spending.

Chairman ROSTENKOWSKI. Mr. Gibbons, you may inquire.

Mr. GIBBONS. Mr. Chairman, I do not have any questions of the panel. I appreciate them coming. I have two observations personally I would like to make.

One is I do not favor any tax increases at this time. I think it is the wrong time with the state of the American economy to try to increase taxes and further add to the burden of the economy by dragging it down more. I think we will have higher unemployment and the same sort of Herbert Hoover syndrome we had in the 1930's.

Two, I do not believe we should make the same mistake, ever since I have been in Congress, and that is to try to stimulate our way out of the position we find ourselves in. There, Mr. Laguarta, I guess I am talking to your organization. I do not believe housing should be used to pull America out of the doldrums. I think we would make the same type of mistake we have made before. We would just kick off another round of inflation.

I still think inflation is the biggest, long-term problem we have and so to that extent I disagree with what you have to say. I have no questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. Some of your testimony is entirely consistent with what the AFL–CIO has recommended before and was, therefore, understandable and predictable, but I am quite astonished at your recommendation that we eliminate indexing. I can only conclude from that that you would prefer to see us financing growth in Government at the expense of preventing the average workingman moving constantly through bracket creep into higher brackets.

It is the working people who get hurt by bracket creep. It is not the people at the top. Indexing is the one thing designed to try to tax income on a real income basis rather than on a nominal income basis and thus to prevent the moving of people into higher brackets.

I cannot understand your taking that position. Would you care to elaborate on it further?

Mr. OSWALD. Sure, Mr. Conable. We believe there are many changes that need to be done in the tax structure and we believe that if people are hurt by moving into the wrong tax brackets, the Congress can make those adjustments. But if there is an inflationary period, we believe that it is precisely at that period that you want the Government to be taking more money out of the spending stream, and that is what happens if you have the normal what is described as fiscal drag.

When you have a recession, as you currently have, the Government should be providing stimulus to the economy and the Congress should be taking action to do that. Having an automatic indexing provision does exactly the opposite. It means that the Government does not help the economy in a recession and in an inflationary period it adds to the inflation by putting that money all back into the spending stream to make it even more inflationary during such a period.

Mr. CONABLE. I note also that you advocate increasing the progressivity of the tax system by giving larger tax cuts at the lower end. We have done that for the last five tax reform measures before this one, thus making it inevitable that the steps in the bracket creep process become bigger and bigger.

Mr. OSWALD. What we are advocating is, if there is to be a belt-tightening in our economy at this particular time, that it be shared and that those who are best able to pay for the needs of the economy do so, that everyone receive the tax cut next year and this year up to $700. Above $700 tax cut that they would be limited to that.

We believe that that sort of equity means that we have a better sharing in our society of those elements that are necessary for the economic recovery that this country needs.

Mr. CONABLE. I thank you for your explanation. It indicates the AFL–CIO is still very strongly in a Keynesian economic kick. I thought we had moved beyond that, but maybe not.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Mr. Chairman, I thank you. I want to make this observation, that this Nation teeters on the brink of a deep recession and possible depression. We must make some vital changes in our economic approach. I think we all agree with that.

This panel, I think, would be typical of the many panels we will hear this week, when each one of you presents your own views and

your own philosophies, as well you should. I like the testimony. I am particularly impressed with the openness of many of you. I found, Mr. Laguarta, that many of your statements I could agree with, but I would hope and I would feel, at least, that the members of this committee recognize that we have to make some big changes.

We must recognize that as a nation we have to do it together. Many of you have testified that you thought the President's program should stay in place and yet you proceed to be against most of the things he is recommending in the tax bill.

Now that is not consistent. Some of you recommended that we keep right on with the present course, to spend more and let the deficit go. So I would hope that nothing is off limits right now. I do not think we just ought to take a position that we are going to be steadfast against any one of these various proposals.

They may all fit into it and I would hope that all us members of this committee and the American people recognize that we have a very difficult problem. There must be a lot of give-and-take and we cannot do it if we dig too deeply into our own philosophies. I just make that observation.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you.

Dr. Rahn, I assume in your testimony you would like to leave the tax cuts in place and move on to further decreases in Federal spending. Is that correct?

Mr. RAHN. That is correct.

Mr. RANGEL. In your testimony, do you outline just what part of the defense spending the increase should be reduced? Or were you just general in your testimony?

Mr. RAHN. We did not get into specifics of the defense spending. Unfortunately, we do not have the depth of expertise, and much of that, of course——

Mr. RANGEL. Well, how about getting into specifics as to what domestic programs you believe that we can cut deeper?

Mr. RAHN. First of all, we think you have to do something about the entitlement programs which have been growing much faster than private-sector wages or the real rate of inflation.

Mr. RANGEL. You called for further reductions in entitlements which are programs designed to service people with the least amount of income, but then you say other nondefense spending. What were you talking about?

Mr. RAHN. We are in the process of putting together a list of additional cuts that we would be happy to supply the committee. We are still working on the details.

Mr. RANGEL. Well, essentially you have just been general. Hopefully, we in Congress will not be voting in general terms, but the members would have to stand up and talk about voting for specific cuts in domestic programs. Were you that general as related to the corporate tax decreases? Was there anything that the President suggested and the Congress passed that you believe was just not sound tax policy and was wasteful in terms of revenue? Were there any other areas?

Mr. RAHN. For example, the all-savers certificates which clearly did not work.

Mr. RANGEL. How about a minimum corporate tax?

Mr. RAHN. A minimum corporate tax would be counterproductive.

Mr. RANGEL. Are there any other tax revenue suggestions that you have, revenue-producing suggestions?

Mr. RAHN. We believe that any major increase in taxes at this time would be counterproductive, would lead to greater rates of unemployment and further financial hardship.

Mr. RANGEL. Doctor, when you talk about further cutbacks in spending, we like to be specific when we talk about a tax program.

Mr. RAHN. I have a list here, sir, of several specific spending cuts, and we will be sending a list up to the Congress.

Mr. RANGEL. Now, when you send that list, Doctor, are you asking whether or not Members will say yes or no to the chamber of commerce?

Mr. RAHN. We are giving you additional suggestions of areas we feel the Federal budget could be cut.

Mr. RANGEL. But are you polling the Congress with this list that you are sending up?

Mr. RAHN. No, we are not polling the Congress. We are giving you suggestions that we hope will be useful to you.

Mr. RANGEL. Someone has indicated that you have sent out to the district chambers of commerce which Members were supporting the chamber and which Members were not and, indeed, were targeting some of them for defeat in the coming elections. Is that so?

Mr. RAHN. We have a list we produce each year of your voting records and how you come down on issues that are important to the chamber. There is a rating, just as the AFL–CIO and most other organizations do.

Mr. RANGEL. How would you rate me when I do not even know which domestic programs you want me to cut? Do you just generally decide which side I would be on without giving me a specific opportunity to show what my tendency would be to vote?

Mr. RAHN. We rate Members on issues which we have taken a clear position on, and hopefully we communicate that in a clear fashion to you beforehand.

Mr. RANGEL. And you have already decided which ones are targeted, notwithstanding the fact that we have not voted yet on the new proposal?

Mr. RAHN. When specific votes come up, specific issues, we state our position as clearly as we can. If, for instance, you voted for repeal of ACRS, it would be a negative vote. If you voted to support that, that would be a positive vote, in our view.

Mr. RANGEL. Are there any Republicans at all on your targeted list?

Mr. RAHN. We have what we call our "opportunity races" of people we would like to see remain in the Congress. We look at marginal races. There are both Republicans and Democrats that we support.

Mr. RANGEL. How about those that you do not support? Are there any Republicans that will not have the opportunity to come back? [Laughter.]

Mr. RAHN. I cannot tell you off the top of my head. Clearly in the past there have been more Republicans who have supported what we consider sound economics, but we see many more Democrats moving over in that direction, and we hope that trend will continue.

Mr. RANGEL. You are very helpful, Doctor.

Thank you, Mr. Chairman. [Laughter.]

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman.

I want to thank the panel for its presentation. I must say that I feel very much like Mr. Pickle on this occasion. I think this is not a good time for nonnegotiable demands on the budget. I think it is time to try to put ourselves together and produce a budget that has a rather low deficit and declining deficits in the outyears by the best means that we can find.

I thank the panel for giving us some help in this regard.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman.

I would like to ask a question of the National Association of Manufacturers. Mr. Huard, the mail from my district tells me people want to knock out ineffective and inefficient programs, whether those are Army tanks that do not work, or food stamps which are subject to a 10- to 20-percent error rate, and therefore somewhat inefficient.

If we looked at last year's tax breaks as if they were social programs, they would be run out of town in my area. For example, last year's tax cuts for corporations, as I understand it, were passed so that business would invest more and make America more productive. Would you agree?

Mr. HUARD. Yes, I would agree.

Mr. STARK. All right. Now the Department of Commerce has just reported that new investment in 1982 will decline by 1 percent. In a January-February survey by McGraw-Hill of the investment plans of 500 major companies, they are predicting a drop of 2.3 percent in productive investment. McGraw-Hill reported that of $345 billion that those 500 companies planned to spend in 1982, only $1 billion was attributed to the massive corporate tax cuts of last year, yet those same tax cuts cost us $10.3 billion in lost revenue. That is a 10-percent efficiency. In other words, for every $10 billion of corporate taxes that we forego, and that cost the rest of us more out of our own pocket, we are only getting $1 billion of investment.

Do you know of any social program that has such a low efficiency or such a low bang for the buck as these corporate tax cuts in terms of increasing productive investment?

Mr. HUARD. I cannot answer that question, Congressman. I have not made a study of efficiency rates of social programs.

Mr. STARK. I thought that is what manufacturing and productivity was all about.

Well, let us try the chamber of commerce, and see. In my local chamber groups, Dr. Rahn, they are made up generally of small- and medium-sized businesses. Last year's tax cut really did not do much for them. Our Ways and Means Committee bill, which your call for action last year in July suggested should be defeated, would have provided about $23 billion more in relief over a 5-year period

without costing the country any more revenue, but it would have directed more of that cut to small- and medium-sized businesses and to individuals who are proprietors. Accelerated depreciation goes mostly to the giant corporations and the tax bill seems to have led to a new wave of mergers which tends to dry up credit for the small businesses.

Now, if you are concerned about small businesses, why would you not support replacing last year's corporate changes with some of the ideas that were contained in that Ways and Means bill? For instance, if we went to expensing of equipment rather than the ACRS, we would help small businesses and large businesses, rather than just concentrating on big firms, and we would reduce the deficit and perhaps end up with more productivity.

What is there about tax breaks for collectibles and kugerands by lowering, say, tax gains on nonproductive assets? Why should we not have restricted our tax cuts to people who actually do invest in productive equipment, and not keep them away from financing mergers and things which help to raise interest rates?

Mr. RAHN. First of all, ACRS was directed at people who really invest. You can only get the benefits of ACRS by investing in real equipment. You cannot get the benefits of ACRS——

Mr. STARK. What about General Electric buying credits?

Mr. RAHN [continuing]. By investing in——

Mr. STARK. What about the people who buy the credits?

Mr. RAHN. Are you talking about the leasing program?

Mr. STARK. Yes.

Mr. RAHN. The goal here was to help out those low-profit or unprofitable industries.

Mr. STARK. Why should they not go broke?

Mr. RAHN. Why should they not go broke?

Mr. STARK. Free enterprise is a two-way street.

Mr. RAHN. We have had a very strong tax bias against them for the past decade, as a result of high rates of inflation coupled with a depreciation system based on original cost. Many of our heavy industries were driven to the point of near bankruptcy. The Congress, and I feel correctly so, voted a bill out to take care of that major problem. There are many other things that many of us would like to have——

Mr. STARK. United States Steel buying a productive oil company rather than an efficient steel mill? How do you wash that one?

Mr. RAHN. If we had made investment in steel more attractive, that would not have happened. Our problem has been that we have had a strong tax bias against capital investment, heavy investment, long-lived assets for more than a decade, coupled with high rates of inflation.

Mr. STARK. That just is not true, Doctor.

Mr. RAHN. That most certainly is true.

Mr. STARK. Do you know that in the major corporate—in the tax bill—that it is possible to get more than 100 percent recovery for capital investments? Are you aware of that fact? That you can invest, under the tax laws, Doctor, you can invest in productive equipment and get more than 100 percent back out of the tax code? Do you know that?

Mr. RAHN. Only if you have other tax liabilities.

Mr. STARK. Oh.

Mr. RAHN. If you are talking about a given investment——

Mr. STARK. How much better do you want us to make it than 100 percent? How much? I mean, you are against big deficits, but we are widening the deficit by helping your corporate members.

Mr. RAHN. Let us get back to what is the goal of any tax policy?

Mr. STARK. Equity.

Mr. RAHN. Equity is your goal? Mine is economic growth. Maybe that is where we differ. I want to see increased real per capita incomes for all of our citizens.

Mr. STARK. Economic growth comes from a decent product sold at a reasonable price.

Mr. RAHN. There is a reason for equity. What do they have? Misery. That is not what we want. We want to increase the economic well-being of our citizens.

Mr. STARK. I think you are quite right, Doctor, we do. All citizens, not just rich ones, and not just the major corporations.

Mr. RAHN. That is right, all citizens.

Chairman ROSTENKOWSKI. Mr. Jacobs will inquire.

Mr. JACOBS. Mr. Oswald, I believe I heard you say, and I see it in your testimony, that you would put a cap, the AFL–CIO would put a cap on the tax cuts at $700 a return? How much would that cut the President's deficit?

Mr. OSWALD. It would bring in approximately $29 billion between 1982 and 1984.

Mr. JACOBS. So it is conceivable that it might cut the Federal deficit of the budget that the President has set up all the way down to what that budget says the deficit will be?

Mr. OSWALD. It would provide a major element of reducing the budget deficit, yes.

Mr. JACOBS. Right.

Mr. OSWALD. Or it could be used to provide other means by which job programs and growth could be encouraged. Our attached description of the alternative program indicates that an important element might be used to provide an aid for housing, direct job programs and other means to bring about economic recovery. In terms of the various economic models, they indicate that clearly one would get greater economic growth by that type of direct economic action.

Mr. JACOBS. Thank you, sir.

Mr. Rahn, the President said a few days ago that the trouble with his personal income tax cut, the reason it did not work out quite as well as he had hoped, was that it did not start soon enough. Do you agree with him?

Mr. RAHN. I most certainly do. The original proposal was for a 10-percent cut last July 1. If we had had that, we surely would not be in the depth of a recession that we are now. Unfortunately, we did not get a 5-percent cut until October 1, which did not offset the bracket creep for most people. Most people suffered a real tax increase during 1981.

Mr. JACOBS. You are saying the original proposal was July 1. The last time you testified before this committee, you agreed that the original proposal was for January 1. You told me I had a hangup about it. Remember?

Mr. RAHN. No. The proposal made in February of last year, February of 1981——

Mr. JACOBS. I am talking about the proposal made before they gave him the job, when he was running for election in 1980. He proposed January 1.

Mr. RAHN. That is right.

Mr. JACOBS. Now what sinister force made him propose July 1 rather than January 1?

Mr. RAHN. I do not believe it was a sinister force. I believe it was the mechanics of putting things together, since he did not take office until January. By the time he got the proposals together and sent them up here——

Mr. JACOBS. Wait a minute. Did someone not call you doctor a moment ago? You are smart enough to understand that these tax cuts can be retroactive, are you not?

Mr. RAHN. But retroactive tax cuts do very little or actually no good. They are just throwing money out of the Treasury. They do not alter——

Mr. JACOBS. But it might have done something to redeem his promise to the American people, might it not?

Mr. RAHN. Pardon me?

Mr. JACOBS. It might have done something to redeem the President's promise in his campaign that he would propose and support a January 1 personal tax cut, would it not? Remember, you said I had a hangup about keeping promises? Remember that?

Mr. RAHN. Well, his promise was to revive the economy through tax rate reductions.

Mr. JACOBS. His promise was that he would support a tax cut for January 1, 1981. That was his promise. You told me I had a hangup about it when I asked you why last summer he was not supporting that date for the effective date of the personal tax cut.

Mr. RAHN. I think the problem was, by the time the tax cut would have gotten through Congress, there would have been a number of months gone by. If you have a retroactive tax cut, that money just is lost to the Treasury. It does not alter the incentives to work, save, or invest, and I think that the——

Mr. JACOBS. But not keeping his word would be just fine with the Chamber? Is that right? I just had a hangup about that?

Mr. RAHN. I did not concede that.

Mr. JACOBS. What?

Mr. RAHN. I am here to the talk about the economic program, not whether the President——

Mr. JACOBS [continuing]. Keeps his word?

Mr. RAHN. Pardon me?

Mr. JACOBS. Not whether the President keeps his word?

Mr. RAHN. I am not here as the representative of the administration today. I am here as the representative of the U.S. Chamber of Commerce.

Mr. JACOBS. But the last time you were here, you were on the transition team for the administration, were you not?

Mr. RAHN. I was on the Advisory Tax Policy Task Force. I was not on the transition team.

Mr. JACOBS. But for the administration. When you told me I had a hangup about wanting the President to keep his word about Jan-

uary 1, you did not understand that. I am merely pointing out to you that the President is now complaining that it would have been an effective tax cut if he had kept his word. Now, to whom he is complaining to about that is the only thing I do not understand.

Mr. RAHN. I suppose in retrospect if you look back at what has happened, we would have been better off with the 10 percent tax cut in January.

Mr. JACOBS. In other words, we would have been better off if the President had kept his campaign pledge.

Mr. RAHN. Yes, sir.

Mr. JACOBS. Thank you.

Chairman ROSTENKOWSKI. Mr. Shannon will inquire.

Mr. SHANNON. Thank you, Mr. Chairman.

Dr. Rahn, you said something that I agree with. Since you did, I think I will seize on that.

Mr. RAHN. We are making progress.

Mr. SHANNON. You have testified about a half-dozen times since I have been on this committee, and I think it is the first time we agree completely. That is, you feel that the goal of our tax policy should be to encourage growth, and I certainly do agree; but I think there has got to be some equity as well.

There is something consistent in your testimony, in Mr. Huard's testimony, in Mr. Laguarta's testimony. That is that you have all come in and urged some changes in the budget. None of you, however, have been willing to put forward what business is willing to sacrifice in order to modify this budget and decrease the deficit.

Let me ask this: Is there a point that this deficit could climb to where you would come in to this committee and suggest any reductions or any changes in the business tax reductions from last year, or would it be your position that changes would be counterproductive no matter what the deficit? That we should not under any circumstances ever consider raising business taxes as a way of dealing with the deficit?

Mr. RAHN. Let me hit that in two pieces. First of all, business we talk about as sort of an abstract notion. We are really talking about individuals. They are the only ones who pay taxes. When we talk about taxing businesses, we are either talking about increasing taxes on consumers by higher prices, or reducing workers' wages. That is how the business tax is passed along.

In terms of what is the appropriate level of taxation for the economy, which I believe is what you are getting at, under the present tax code that you all enacted last summer, by the time it is fully phased in in 1986, it will account for about 19.7 percent of the GNP. Right now Federal spending is running at about 23½ percent of GNP.

The question is then whether or not the Congress is going to ratchet down Federal spending as a share of GNP. If you do, then the deficits over time will disappear, and we will not have the problem. If you do not, if Federal spending increases as a share of GNP, clearly at some point we will have to increase taxes. That will lead to economic stagnation and less real growth.

Mr. SHANNON. Let us assume we can agree on an appropriate level of taxation. I am talking about how we distribute that taxation, whether it should rest directly on individual taxpayers or

whether we should try to distribute some of that on the business side as we traditionally have done. Can you imagine any level of deficit where you would come in to us and say: Make a change in the depreciation so it does not cost so much; or make a change in the corporate tax rate so that we do not lose so much revenue there; or make a change in the oil taxation so that we can pick up some more revenue there.

Is it conceivable for you to imagine any level of deficit where you would come in as a representative of the chamber of commerce and suggest that?

Mr. RAHN. If you are asking me, is it conceivable that at some time we would call for a tax increase, clearly that is conceivable.

Mr. SHANNON. Not just by increasing the tax burden on individuals.

Mr. RAHN. But if you were going to increase taxes, then we want to do it in the least harmful area to the economy. Most economists of a broad spectrum agree that particularly the corporate tax is a counterproductive tax.

Mr. SHANNON. So any kind of increase in the business taxes would be out of the question as far as you are concerned?

Mr. RAHN. Again when you are talking about taxes on business, you are talking about which individuals do they impact.

Mr. SHANNON. I am talking specifically about changes in depreciation, or increases in corporate rates. Would any kind of suggestion of anything like that be out of the question, as far as you are concerned?

Mr. RAHN. I would prefer to see real rates of economic growth rather than "higher" rates of economic growth.

Mr. SHANNON. Mr. Huard, how about you?

Mr. HUARD. I learned a long time ago that I should avoid saying "never." I will say that I find it difficult to conceive of a situation where we would support increasing corporate tax rates or cutting back on the depreciation that was enacted.

Now I think, and I alluded to this in my testimony, you are dealing with a tax cut of $750 billion over 5 fiscal years. The business community only got 20 percent of that to begin with. That 20 percent was primarily, I say almost nine-tenths of it, through the ACRS system. It was directed at stimulating investment in plant and equipment. Now to me, that translates into increased productivity and increased jobs. If you take that away——

Mr. SHANNON. Is there any level of deficit where you think those goals come into conflict and you would be willing to come in and say: "Make an adjustment so we can reduce the deficit in the short run, it would be in the best interests of the economy to do that"?

Mr. HUARD. Presumably, there is. I find it difficult to conceive of the deficit getting that large.

Mr. SHANNON. But we are not there, yet?

Mr. HUARD. No.

Mr. SHANNON. How about you, Mr. Laguarta? You have come in and asked us to do a little more tax spending this year to stimulate the housing industry. I guess you want us to finance it by taking away individual tax cuts and indexing. Is there any level at which you would come in and say: "Make some changes in depreciation or business taxes or corporate rates or any other little goodies"?

Mr. LAGUARTA. Well, first let me clarify what we came in here asking for. We did not come in here asking for 1 penny that would further exacerbate the budget deficit. What we came in here saying was: "You have already passed a law dealing with revenue bonds. We are saying those funds are not going out into housing. You must have intended those funds to go to housing or you would not have passed the legislation."

Mr. SHANNON. What about the tax credit that you have asked for? Is that not going to cost the Treasury some money?

Mr. LAGUARTA. Sir, we have expressed that the money that you allocated when you passed the all-savers program could be used to fund the tax credit. The all-savers program was tied specifically to housing. When that program ran into a brick wall at the start of this year, and no more funds came in through the all-savers program, it did not——

Mr. SHANNON. That is new tax spending you are asking for.

Mr. LAGUARTA. Just a moment, sir. The money has not found its way into housing, which was the intent of Congress. What we are proposing is——

Mr. SHANNON. I was here when the all-savers certificate went through. I do not think that the primary intent of all-savers was to help housing. I do not think that that is what we were talking about at that time. We hoped it would help housing, but that was a secondary intent for many of us. Is there any level of deficit at which you would suggest coming in and making changes in business taxes?

Mr. LAGUARTA. As far as the deficit is concerned, what we have continued to espouse as far as a program for our national association, which has been consistent for 3 years, is to start with spending cuts, and to look at every program——

Mr. SHANNON. Our time is up, and I have to go vote, but I just want to say that, you know, all of you are quick to come in and say that everybody has to make sacrifices except yourselves. I think that on both sides of the aisle we understand that there is a budget crisis in this country and we want to deal with it; but we have difficulty really accepting your suggestions unless you are willing to show us the ways in which you yourselves are willing to tighten your belts and are willing to sacrifice, and we will be looking to you for that in the next few weeks. Thank you.

Mr. RAHN. Mr. Shannon, slow economic growth hurts business people just as much as anybody else in the economy.

Mr. GIBBONS [presiding]. Mr. Bailey, and then we will go to Mr. Martin.

Mr. BAILEY. Thank you, Mr. Chairman.

Mr. Rahn, I am a little confused. I will be honest with you. Maybe confused is not the right word, but the way your statements are presented, are you telling your membership and dealing with your membership—"The Chamber remains firmly committed to the administration's four-point economic recovery program of tax cuts," et cetera, et cetera. Page 7. You are talking about the alternative minimum corporate tax and in theory about the minimum corporate tax, of course, and you go on to say that the business deduction is properly taken from income as a result of congressional desire. Are these not Presidential proposals? The alternative mini-

mum corporate tax is an administration proposal. You are opposed to President Reagan's recommendations on the alternative minimum corporate tax? Let us get that on the record if that is your position.

Mr. RAHN. That is correct, and we of course have let the administration know that.

Mr. BAILEY. You are opposed to President Reagan's alternative minimum corporate tax. Are you communicating that to your members?

Mr. RAHN. Surely.

Mr. BAILEY. Mr. Huard, the Manufacturers Association, you folks—you do not need that piece of paper. This statement is pretty good. I know you think for yourself. You are opposed to the administration's recommendations on the alternative minimum corporate tax. Am I wrong?

Mr. HUARD. Yes, we are.

Mr. BAILEY. You are telling your members that? Next time I read your voting tally there I am just curious to see what——

Mr. HUARD. We most certainly are telling our members that.

Mr. BAILEY. You are communicating that to your members?

Mr. HUARD. From the board of directors' level all the way down.

Mr. BAILEY. All right. Now you oppose President Reagan's changes in that regard, so therefore if we are talking about the support for the administration's programs among you two folks, which represent a very significant portion of the business community, we are talking about opposition, open, notorious, public, honest, candid opposition to administration recommendations which you feel would alter the investment incentives that would help boost the nation's productivity by means of encouraging reinvestment in the Nation's plant and equipment. Is that correct?

Mr. RAHN. That is correct.

Mr. HUARD. That is correct.

Mr. BAILEY. That is clearcut and correct. I thank you very much. That clears some things up for me, because every time I read these statements here it was hard for me to find things. In fact, until I got back to your conclusion from NAM, it was hard for me to see how those things tied together.

Dr. Oswald, the theory of refundability, the theory of transferrability, if I am not mistaken, is something that in terms of assisting this Nation's aging plant and equipment capacity is something that the AFL–CIO has supported. Is that a fair statement? The theory of refundability, refundable tax credits?

Mr. OSWALD. We have supported direct tax credits to be allocated through a reconstruction finance corporation, which would do an evaluation of the need and the results rather than a blanket open-ended across-the-board equivalent appropriation through the tax mechanism.

Mr. BAILEY. I have agreed with you, and I still agree with you on that theory and that idea, as you probably know, very, very strongly. In fact, I have read the AFL–CIO platform and I honestly wish more of our business people would read it, because I think there are some basic ideas in there, some common ground that I think we could work with. Now, I do not know if we agree in this area. Please, I hope that we do, because I think it means jobs. Could we

possibly—I am really sticking my neck out here, so bear with me—do something in the area of modifications, at least in that leasing area? I understand the difficulties with it but some ideas that will enable us to make sure that those benefits are directed solely into job increasing productivities, improvements, that that is at least a potential vehicle for accomplishing reinvestment purposes if it is cleaned up?

I understand your objections to it as written, but could you offer some commentary on my very vague and elusive question?

Mr. OSWALD. We believe very strongly that there are certain industries that may need temporary help where new investment would be an important element of making that industry long-term and viable. We believe that leasing, though, is not a very good means of making that decision.

Mr. BAILEY. As written, not the most efficient vehicle.

Mr. OSWALD. And you are spending an awful lot of money for things that allow more profitable corporations to benefit as a result of the lease. We would prefer that this be done, again, through a reconstruction finance corporation, something that not only the AFL-CIO is recommending; but people on Wall Street and other places that think this is an effective means of allocating scarce resources.

Mr. BAILEY. I am very pleased with that answer. Thank you.

Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. Martin.

Mr. MARTIN. Thank you very much, Mr. Chairman.

Mr. Laguarta, you made several proposals to the committee relating to the recovery of the housing industry. I am sure you have inferred from some of the questions and commentary from members of the committee and the panel that some of the proposals might be difficult to implement. Nevertheless, this may be the only hearing that we may have on this subject, so I wanted to pose to you some questions so that we may have a wider exploration of some of your ideas.

First of all, on page 5 of your prepared testimony, you encourage us to move forward with the mortgage revenue bond amendments, which in their present status would limit the use of mortgage revenue bonds in certain ways; but the virtue of these amendments is that they get the program moving again from the hole where it is. As you mentioned, it is presently tied up on the Miscellaneous Revenue Act of 1981.

Yesterday, President Reagan proposed to you that the administration is going to bring out some much needed regulations in this area, so it seems to me that a question needs to be asked whether it is better for the Congress to move forward or to wait until we know what those regulations are going to be. By waiting we will know what they have to say specifically about arbitrage and what they have to say specifically about the uncertainties of rigid rules that would make bond issues disqualified after they have already been sold.

Mr. LAGUARTA. Well, I believe you are aware of the degree of pain in the housing industry and the lack of access to housing in our country today. Certainly we should not be here asking for time to extend any sort of program which would address that. Nonethe-

less, it seems to me it would be prudent to review the specific recommendations that come out of the administration before proceeding in Congress.

I believe the President indicated on the arbitrage problem that there would be an improvement of something in the range of 20 to 40 basis points. If the regulations come out in that range, that may cover that particular program, but that is an example of the type of thing that I believe should be examined.

Now, if for some reason the administrative changes are delayed, and a great period of time passes, then this program in its present form would not go anywhere. Without some change from either you people over here in the legislative side or from the President's side over in the administration, this program is not workable.

Mr. MARTIN. Thank you, sir.

You have also proposed, among other ideas, a tax credit or some other device to encourage first-time home buyers, which I suppose, make up something on the order of about, what, 20 percent of the market you are dealing with?

Mr. LAGUARTA. Yes, sir.

Mr. MARTIN. As you know, Mr. Jenkins of this committee and I have introduced H.R. 5948, which I believe has been endorsed by your association board. The bill would provide a 9 percent tax credit to a first-time home buyer on the first $60,000 of the purchase price of a home. The $60,000 limit would not be a qualifying ceiling, but for example, a $70,000 purchase price would be eligible for the credit up to only the first $60,000. It has a recapture provision for those who are just speculating, so that if you resell it within 3 years it has to be recaptured.

It also certifies the seller to certify that the price at which it is sold is the lowest price at which it is offered.

I wonder if you and your associates have made estimates of the cost of this proposal based on your experience with the housing market.

Mr. LAGUARTA. Our economic models have indicated to us, Congressman, that we are talking about something in the range of $2.6 billion to $3 billion, something in that range as far as the impact on the Treasury. We are proposing to make up for that additional revenue loss by ending the all-savers program so that the money that is left in that program can be substituted for the cost of the program on the mortgage tax credit.

Mr. MARTIN. Is that estimate of $2.5 billion to $3 billion per year, or over a 2-year period?

Mr. LAGUARTA. That is over the life of the program, which would sunset December 31, 1982, as does the all-savers program. It sunsets at the same time.

Mr. MARTIN. So it would be over the entirety of the 2 fiscal years in which the tax effect would be realized?

Mr. LAGUARTA. Yes, sir. We believe it would stimulate something in the range of 250,000 home sales that would not ordinarily take place by helping first-time buyers who are having a heck of a time qualifying for loans and paying the high mortgage rates on the conventional loans.

Mr. MARTIN. There are some alternative proposals that deal instead with the limited market of the new construction and existing

inventories. Of course, that would be of some value to the first-time home buyer also, but would you care to compare or contrast the relative merits of these two approaches, as to which is a more level field for the housing industry?

Mr. LAGUARTA. I am here as a proponent of programs for the housing industry, but clearly the American public out there does not differentiate between a new home and an existing home. What they want is decent housing. They are not discriminatory in their outlook on satisfying their needs. Also, I do not believe we have done as good a job as we should have in relating to you people in the Congress that there is a big economic stimulus that occurs when an existing home sale takes place. People come in. They fix that place up. They put in new carpet, new drapes, buy lawn furnishings. There is an economic stimulus. So we think that a balanced program would deal with both of the opportunities, that is, to create new starts which would help the construction industry, and to stimulate the sale of existing homes.

Mr. MARTIN. Thank you, Mr. Chairman. My time is up.

Mr. GIBBONS. Mr. Heftel.

Mr. HEFTEL. Thank you, Mr. Chairman.

I do not know if I should ask questions or just make comments, because I think that we all know what we were being told in the Congress a year ago. Some of us tried to suggest that the program that was finally passed last year could not work, that it would not have the desired impact on productivity and interest rates, nor would it do anything about what was wrong with the economy. But, unfortunately, the President bought a package written to a very great extent by very competent legal counsel for many of the people that you represent. As a result what we now have in place serves only the most profitable. It does nothing to help any company that might be considered marginal in profitability.

In fact, when we do help the less profitable, we do it at a great cost to the Treasury, because of the gimmick in the leasing provisions. They are written in such a way that when I as an undercapitalized, marginally profitable business, find that my only way out is to sell my tax credits, I sell them to a profitable company, which in turn uses those credits to get a healthy writeoff as a return on its investment in them. But whatever the return may be, the profitable company gets a benefit which in fact is more costly to the Treasury than if the Treasury in the first place had extended refundable tax credits to those firms that we wanted to assist.

That is just one example of the problems with the program we now have, and the whole program is not rising or falling because of it. But nobody looked at what you sold us, and to find you back here a year later acting as though you did not sell us a pig in a poke is incredible. I would have anticipated that you would have come here today and said that we as a nation have a problem, we cannot come here and only represent the most profitable and the largest businesses of America. We have also got to look at the 70 or 80 percent of America that is slowly going under one way or another.

Now, if we listen to you today, we will compound the problems of what we did a year ago. We have to recognize that we are suffering today from what we did a year ago, which resulted from our listen-

ing to you then. If we do not develop our own knowledge and our own courage to act independent of the kind of advice you give, we are going to be in worse trouble. I sincerely hope that somehow the President and his administration realize that they bought a pig in a poke. It does not work. You only represent a fraction of American business, and then only the most profitable, and what we have done is encourage a system in which the most profitable sit in place and wait for the less profitable to go under, and then pick them up, 10, 20, 30 cents on the dollar. The reason we are not seeing any movement in the economy the way we had hoped is because those who have money can simply do better by buying that which exists at less than what it is worth.

With these interest rates, much of America will go under because it cannot stay alive. It cannot afford the building materials. It cannot afford the cars. It cannot do all the things that you have to do to stay in business.

We have the realtors here today asking us to do something we should have done a year ago, telling us what we knew a year ago when we said all-savers cannot do anything for the building industry of America. But until this committee and the Congress act independent of the kind of advice that comes from special interests with certain clients, this Nation is going to be in worse trouble before it gets out of the difficulty it is in.

Thank you, Mr. Chairman.

Mr. GIBBONS. Thank you, sir.

Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

I want for just a minute to welcome Mr. Laguarta to the committee and tell the committee that I am not prejudiced just because he is a constituent of mine, but he is the kind of person who is not special interest oriented, but is interested in his community and his country. I want to personally welcome you to our committee. I think the thrust of your proposal is good. There might be a few minor things in there that I might not be totally in harmony with, but I want to thank you for the thrust of your proposal.

I would like to ask, Dr. Rahn, you say that we should cut spending, and I agree totally with that as a means of trying to shrink this deficit. That should be our first obligation, to cut spending. But I am puzzled when I look at your voting record for the last year, where you show a bad vote for those of us who believed we were spending too much on foreign aid. The foreign aid in our budget went up 14.3 percent over the previous year, yet in your voting record you recorded the vote for increased foreign aid as a good vote.

Now, if we are not going to include foreign aid in our overall consideration for reduction in spending, how are we going to get our spending down?

Mr. RAHN. Our votes are based not only just strictly on economic matters, but also international strategic matters dealing with our foreign neighbors, and the less developed countries, and so forth. That particular vote is outside my area of expertise, and I cannot give you all the explanation for why that was listed, but I would be happy to provide, make sure that we do provide you with a detailed explanation of why we took the position that we did.

Mr. ARCHER. I would like to ask all of you gentlemen this. Assume that each of us would like to see as much as we can done on the spending side of the budget; and while we might disagree as to where we would want to make those reductions in spending, we would certainly believe that we should eliminate waste and inefficiency, and get the Federal budget down as much as possible.

Let us assume that hypothetically we are able to get this budget down on the spending side to where we have a $100 billion deficit facing us for 1983—I think this is a reasonable sort of a figure to look at—with expanding deficits thereafter in 1984 and 1985 and 1986. How many of you believe that we should not close that deficit gap by some sort of increase in tax revenues? Do all of you agree that if we have done our best on the spending side, and we are looking at a $100 billion deficit in 1983, that we should then consider some source of increased revenues to reduce the deficit?

Mr. RAHN. No, I do not agree with that.

Mr. ARCHER. You think a $100 billion deficit is OK?

Mr. RAHN. No, I do not think it is OK. I do not think we have to live with that. Again it gets back to the question, do we want Government to be a smaller segment of GNP or a larger share of GNP.

Mr. ARCHER. We have already made that decision. We have cut spending by consensus, not as much as I would like to cut it. I do not run the whole Congress, but we have determined to cut the spending budget. We have gone as far as the Congress by consensus will go. This is the reality of where we are. Then what do we do about this deficit? I assume you are saying don't raise any revenues?

Let me say this to you. We have two ways of handling a deficit. I do not have to be a big economist to understand this. You either handle a deficit by borrowing every penny of it or you raise money through the Tax Code to cover at least part of it. Now, if you borrow every penny of it, every dollar comes out of invested capital savings, every single dollar. If you do it by taxes, you can create a mix where part of it will come out of consumption and part of it will come out of capital savings.

I understand you are telling me that you would rather have every dollar come out of capital savings. I am surprised at that.

Mr. RAHN. I would argue that there are some taxes which are better than others clearly in terms of the impact upon the economy. I feel it would be premature to concede that Congress cannot bring down Federal spending as a share of GNP. We look at the growth of entitlements, and a number of the other areas. These are still growing far faster than private sector income and the rate of inflation.

Mr. ARCHER. I understand that. We have to get a consensus on the spending, whatever it is. I am assuming we do the best we can do with this consensus. I do not expect you to say no, the spending level is okay. It will not be OK with me, either, but we have to cope with that.

Now, I would like to say one other quick thing. On the side of the business reductions, which were mainly in the depreciation area. Depreciation is not a revenue loss. It is a deferral of taxation, that is all. In the immediate budget it may show as a revenue loss, but over the long term it is just a deferral. We did a lot for simplifica-

tion in this area which cuts out the paper work and eliminates the need for IRS revenue agents and everything else. I personally think to try and undo that would be a big mistake.

Thank you very much.

Mr. OSWALD. Mr. Archer, if I may, our testimony did provide the example of $47 billion of additional revenue raising proposals for dealing with the sorts of questions that you raised.

Mr. ARCHER. Thank you very much.

Mr. GIBBONS. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

I would just like to make one comment first, and then ask a series of questions. I would like to direct this comment to the National Board of Realtors, Mr. Laguarta and Mr. Carlson. I think your testimony was very fair, and you are looking at it from a perspective of the national interest rather than your own specific interest. I also appreciated reading your comments Mr. Carlson—the comments you have made over the last 6 to 8 months. I think they were very important to set at least a national dialog in terms of the administration's package presented to us.

In addition to that, since your industry and the auto industry are the two interest-sensitive industries that have been impacted so negatively by the high interest rates over the past 24 months, I think, contrary to some members, that we have responsibilities to both of your industries. I have some problems with the Lugar bill, and I am certainly happy that Mr. Frenzel and Mr. Jenkins have introduced the proposal you are advancing, and I would like to work with you in those areas.

I would like to ask a question of Dr. Rahn, if I may. I am a little confused here by your testimony. According to the CBO, the baseline deficit figure for 1983, along with the projected increases in defense spending by the President, will be $168 billion. Let us assume for a minute that those figures are in fact correct. You have a three-point proposal: reductions in entitlement, nondefense spending, smaller defense increase, and freeze in COLA.

You have excluded the individual and business tax cuts that were passed last year. Just following up on what Mr. Archer said, I would like to be a little bit more specific if I may. Now, what are you proposing in terms of aggregate dollar amounts, in terms of the defense spending? I do not even care where you would make the cuts. I want to know how much in terms of dollars would you cut the defense budget.

Mr. RAHN. In terms of the actual dollar amounts for the defense budget, we do not have a specific recommendation for you yet. We are working on that. We are probably not going to be able to come up with a precise number just because we plainly do not have the expertise. We have been looking at a number of other studies. We have seen some good suggestions out of CBO, the Heritage Foundation, and a number of other organizations. Some experts in defense spending seem to feel that there is excessive spending, as do a number of our board of directors who are involved in the defense industry.

Senator Tower, for instance, has come up with $2 billion. I look at that as the very minimum. It would have to be something probably beyond that.

Mr. MATSUI. Let us assume just for a minute, Doctor, that we could cut $8-10 billion. Let us say we can take eight to ten to be on the safe side. We take $10 billion out of defense. I suppose that would really be squeezing it, because most people, even the more liberal members of Congress, say eight is more accurate. As far as the entitlements and the COLA, Mr. Domenici's package, which includes a freeze on COLA in addition to the freeze on medicaid and medicare, that comes to $36 billion. So you are talking about $46 billion. Subtract that from the $168 billion that we originally were talking about, and you are talking about a deficit still in the neighborhood of $130 to $140 billion.

Mr. RAHN. We think those deficits are high. We have a forecast center at the chamber, and our estimate for 1983 is a deficit of $110 billion, and we are taking out——

Mr. MATSUI. Is that the baseline deficit without the President's cuts?

Mr. RAHN. No, that is assuming——

Mr. MATSUI. We cannot assume the President's cuts, because we have already said the revenue increase is not any good.

Mr. RAHN. No, we have said they were cuts of $31.5 billion off baseline.

Mr. MATSUI. So you are talking about a deficit of $140 billion. That is the baseline figure, $145 billion perhaps?

Mr. RAHN. Yes.

Mr. MATSUI. OK, let us use your figures, for example. Let us say $145 billion. We lop off $46 billion. We do everything you want us to do. You are still at $100 billion. Can you live with that figure?

Mr. RAHN. Given the alternatives, which seem to be worse, it is not a good figure, it is not something we are happy with; but the alternative seems to be far worse.

Mr. MATSUI. I want your answer because I am going to go back home during the Easter recess and I want to be able to say if we do those things to reach $100 billion deficit, the U.S. Chamber of Commerce has bought onto the program and they, in fact, advocate a $100 billion deficit. It is the lesser of the evils.

Mr. RAHN. No, we are not advocating a $100 billion deficit. We are saying that is preferable over a tax increase.

Mr. MATSUI. You will say that you are going to support a $100 billion deficit if we come up with a package like this.

Mr. RAHN. We think that the Congress probably can do better in terms of cutting spending.

Mr. MATSUI. Well, tell me how. I want to know your bottom line. You have got $36 billion in cuts and entitlements in COLA and we have got $10 billion out of defense, which we know we cannot get, so we are down to $100 billion. Using your economic assumption now, do you support that $100 billion deficit? Tell me now, yes or no.

Mr. RAHN. We support that over an increase in taxes.

Mr. MATSUI. Fine. So you support that, I am assuming, because you do not want to increase the taxes; is that right?

Mr. RAHN. We do not want an increase in taxes.

Mr. MATSUI. Thank you. I have no further questions.

Mr. GIBBONS. Mr. Guarini.

Mr. GUARINI. Dr. Rahn, on the safe harbor tax leasing, you have no recommendations to change it, whatsoever?

Mr. RAHN. We have said if there are areas of demonstrated abuse we would surely accept modification.

Mr. GUARINI. Let me ask you——

Mr. RAHN. We of course are for the most efficient form of trying to take care of the problems the Congress tried to deal with last August.

Mr. GUARINI. Now according to Secretary Donald Regan, a study has shown that tax leasing helped the rich. Do you subscribe to that?

Mr. RAHN. Secretary Regan said tax leasing helped the rich?

Mr. GUARINI [reading from document]. "According to a study of corporate tax sales under the controversial leasing provision, Secretary Donald Regan said yesterday tax leasing helped the rich." Do you accept that statement? Have you done any studies on it?

Mr. RAHN. We have not done any studies yet, no, sir.

Mr. GUARINI. Furthermore, the oil industry is the largest buyer of these tax breaks. Do you understand that to be a fact?

Mr. RAHN. I do not have all the specifics in front of me, but I would not dispute that.

Mr. GUARINI. But you are not surprised that the oil interests are the ones that have used the tax leasing provisions the most to their advantage, therefore deferred——

Mr. RAHN. They have had a higher cash flow. That seems logical, yes, sir.

Mr. GUARINI. Therefore, the beneficiaries of this are the oil companies.

Mr. RAHN. I think the beneficiaries would have to be the ones who are lessees, not just the lessors. We would have to look at the other side of the equation there to get a fair evaluation of the impact.

Mr. GUARINI. What specific provisions would you limit on the safe harbor tax leasing?

Mr. RAHN. We have not yet developed a specific list. Our tax committee has been studying it and working with the Treasury.

Mr. GUARINI. So you have not thought it out thoroughly and taken a firm position on it?

Mr. RAHN. We have said that if there are demonstrated abuses, we would not oppose any modifications of those. We believe on balance that leasing adds efficiency to the economy and has helped facilitate the usefulness of ACRS.

Mr. GUARINI. What is your position toward the provision that the key defense contractors are using now to defer taxes on the completed contracts? Are you against that abuse?

Mr. RAHN. We have that under study. We have not taken a position on that yet.

Mr. GUARINI. What is your position concerning the fact that the IRS estimated that 44 percent of all capital gains are not reported to the Federal Government?

Mr. RAHN. We have supported the IRS request for increase in personnel for their compliance staff.

Mr. GUARINI. Would you support the view that if a man has to have a W–2, that the man on Wall Street has to have a W–2 form, that the man on Wall Street has the same responsibility?

Mr. RAHN. We clearly support tax compliance. When you talk about additional reporting requirements, you have to look at the costs and benefits of each of those and the technical feasibility and so forth.

Mr. GUARINI. The fact is that half the money is not being reported. Does that not disturb the Chamber of Commerce?

Mr. RAHN. Surely it bothers us. I am not sure it is the people on Wall Street.

Mr. GUARINI. You do not think Wall Street benefits by this, or the large corporations, by the turning over of stocks and bonds?

Mr. RAHN. I do not think that the large corporations are the ones who are not reporting. Most of them have IRS agents in their shops. They tend to be very careful about full compliance. The underground economy, as I think is quite widely known, tends to be with smaller individuals. In fact, on the way up here today we were discussing the testimony, and the cab driver said he has not paid any taxes since 1963. I think that that is the area of the economy you have much more abuse.

Mr. GUARINI. I could be more forgiving to him than I could be to Occidental or General Electric that reports $2.6 billion, sir, and did not have to pay a cent; whereas the man who earns $18,000 has to go to a finance company to try to pay for his home and shelter, and the food for his table.

Let me ask you another question. Are you at the chamber of commerce concerned that the all-savers bond is not being applied toward housing, but that commercial banks have got the benefit while the thrifts are now going broke?

What is your position on that in the chamber of commerce?

Mr. RAHN. In terms of all-savers, we were never active supporters of that. We did not think that was a good device for increasing the stock of savings.

Mr. GUARINI. So you have no recommendation for correcting the all-savers program so that its funds go to other purposes?

When you do not listen, sir, you cannot answer the question properly.

May I just ask, before my time runs out: One of the biggest problems we have is minority unemployment especially of our youth, which is perhaps 50 percent. Getting down to the grassroots problems in our society, this costs us a great deal of money in order to maintain these people through different forms of Government benefits. On the other hand, we talk about cutting spending.

What position or what recommendation does the chamber of commerce have as to how we can put our minorities back to work again? Have you given full consideration to that particular grassroot problem?

Mr. RAHN. Yes. That has been a key concern of ours. It gets back to the point I was trying to get at earlier. We have often gotten away from what I think the true goal of our economic policy should be, that is, rapid economic growth to create new opportunities, to create more jobs throughout the society. Over the decade of the 1970's, Federal spending increased three-fold. We have massive in-

creases in public employment programs, CETA programs and so forth, yet the individuals who are supposed to be benefited by those, their unemployment rates soared. Clearly, those policies were counterproductive, they did not work.

What we are saying is that by reducing the impediments, by encouraging rapid economic growth is the way we create job opportunties, is the way we pull people out of poverty. Look at the way our economies grew in the past. In the mid-sixties up to the tax cuts, poverty was reduced, unemployment for all groups, in particular teenagers and minorities, went down. The same thing happened in the 1920's.

Mr. GUARINI. My time has run out, but if supply side economics is not working and 50 percent of our minority youth are unemployed, has the chamber got a policy it offers to Congress other than saying do not raise taxes for our business people?

Mr. RAHN. First of all, I dispute the notion that supply side economics is not working. We had a 5-percent tax cut last year, which did not offset bracket creep. People suffered a tax increase last year. It is not until July 1 this year that you have the first of a supply side tax cut. People are blaming the recession on a supply side program that has not even gotten into effect yet.

Mr. GUARINI. Lastly, instead of arguing the supply side, which apparently would be a disagreement as to whether it is working or not with you, sir, I can understand that. Is there any positive program the chamber has for unemployed youth in our country today?

Mr. RAHN. We have supported the enterprise zone concept. We do not look at that as a great panacea. We look at that as a useful experiment. The positive program that we have advocated, again, was a program to have rapid economic growth. It has worked in the past in this country; it has worked around the world. The income transfer payment programs clearly have not worked.

Mr. GUARINI. Thank you, sir.

Mr. GIBBONS. Thank you, sir.

Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

I guess I would like to direct my first question to Mr. Rahn and Mr. Huard—is that correct?

Mr. HUARD. "Heward."

Mr. PEASE. "Heward"? Thank you very much.

You have both signed on for your organizations to the President's economic recovery program almost without change except to oppose any change he wants to make in the tax area. I presume that the people who belong to your two organizations also belong to the business roundtable, yet we are hearing a different story from the business roundtable.

Would you comment or suggest why that may be?

Mr. RAHN. I would be happy to comment on that. First off, the U.S. Chamber represents more than 230,000 businesses directly. We also represent about 2,600 State and local chambers, and about 1,700 associations. The business roundtable represents, as you know, a very small group. More than half of our members pay taxes as individuals. They are partnerships or sole proprietorships. So of course they are greatly concerned about the individual tax rate cuts.

The only way they would get any benefit from rate reduction is as individuals. I think that explains a good deal of the difference in the point of view.

Again, we have been most concerned about increasing economic growth and increasing real per capita incomes for all of our citizens.

Mr. HUARD. We represent 12,000 manufacturing concerns. The majority of those have 500 or less employees. The business roundtable represents 196 of the largest corporations in the United States. Not all of them are members of NAM, and indeed they are not, although a good percentage are. We frequently are in agreement with the roundtable but we do not march lock-step with them nor they with us. There is a wide difference in their membership and ours, particularly in the area of small business. We represent many, many small manufacturers.

Mr. PEASE. Thank you very much. That is helpful.

I would now like to turn to the deficit figures and just to ask the two of you in particular as economists what your feelings are about the discrepancy between the OMB projections for deficits over the next 3 years, and those of the CBO. The administration budget calls for deficits over the next 3 years, if their spending cuts and tax cuts are accomplished, of $92 billion, $83 billion, and $71 billion.

The Congressional Budget Office reestimates the administration's budget with the same assumptions as far as spending cuts and defense and so on and comes up with $122 billion, $129 billion, and $136 billion. Which one of those is more accurate?

Mr. RAHN. When you make a forecast you have to make certain assumptions about the rate of inflation, when the economic recovery will take place and the strength of that recovery. Our figures are not quite as optimistic as the administration's, but they are more optimistic than the CBO's. We have a pretty good track record and I feel pretty confident about the numbers that we have.

Mr. PEASE. Would you tell us what your figures are for those 3 years?

Mr. RAHN. For 1982, $102 billion; for 1983 $110 billion; for 1984 $114 billion.

Mr. PEASE. So even if the President's suggestions are adopted, you would see growing deficits?

Mr. RAHN. No, we assume that not all the President's suggestions would be adopted.

Mr. PEASE. I see.

Mr. RAHN. We are hopeful that they would be, but given the past record of Congress, we assume you would not make all of those cuts. We were trying to come up with realistic numbers rather than our wish.

Mr. PEASE. I see.

Mr. Huard?

Mr. HUARD. Congressman, I have the severe misfortune to be encumbered with a legal education. I am not an economist; I am a tax attorney. I feel reasonably confident in discussing tax policy. As to the mechanics of forecasting deficits, I have no opinion.

Mr. PEASE. Thank you.

One last question before my time runs out.

Mr. Laguarta, I would first like to commend your organization for last year suggesting some moderation on the tax side. If we had taken your suggestions last year, we would probably not be in the pickle we are in now, or at least not as far into it as we are now.

I would also like to commend you for coming up with some positive suggestions to try to get something done this year. I think they are very helpful.

I recall that 2 years ago you were able to project unemployment increases, the loss of jobs in specific congressional districts all across the country based on how Members of Congress voted on various proposals. I am just wondering if you had done the same thing in relation to the economic recovery votes that were made last year.

Mr. LAGUARTA. Yes, sir. Our program is the same kind of program that we have had in the past. What we are trying to do is come up with the best economic models that we know how to either forecast the economy or to forecast whatever comes out of either the Congress or the administration, as to how those policies impact our industry and those key components of it. We expect that we will have that in the mail by sometime in the middle to the late summer.

Mr. PEASE. Will you be publishing a report sometime this year showing how many jobs were gained or lost in each district according to how members voted on the President's economic program?

Mr. LAGUARTA. Yes, sir, we will.

Mr. PEASE. You will?

Mr. LAGUARTA. Yes, sir.

Mr. PEASE. I look forward to that with great interest.

Mr. LAGUARTA. We do, too. [Laughter.]

Mr. GIBBONS. Let me make a closing observation. I have found from 30 years of legislative experience that you will vote better, live longer, and enjoy it more if you do not give a damn about how you folks rate us, all of you.

We thank you very much for coming here and we appreciate your contribution.

Mr. LAGUARTA. Thank you, sir.

Mr. GIBBONS. Let us all sit down and get started, if we can. I am going to call on you as you are listed here.

On my agenda sheet, our first witness will be Mr. James M. Hacking, who represents the American Association of Retired Persons, and National Retired Teachers Association.

Mr. Hacking.

STATEMENT OF JAMES M. HACKING, ASSISTANT LEGISLATIVE COUNSEL, AMERICAN ASSOCIATION OF RETIRED PERSONS AND NATIONAL RETIRED TEACHERS ASSOCIATION, ACCOMPANIED BY ROBERT BRUNNER, LEGISLATIVE REPRESENTATIVE

Mr. HACKING. Thank you, Mr. Chairman.

I am accompanied by Mr. Robert Brunner, one of our legislative representatives. We are here representing the NRTA and the AARP, which together have a combined membership well in excess of 13 million people aged 55 and older. With your permission, I will

submit the association's statement for the record of the hearing and proceed to summarize.

Mr. GIBBONS. Yes, sir. And all statements in this hearing will be included in full in the record. Witnesses may summarize if they wish.

Mr. HACKING. Thank you.

The elderly of this Nation recognize that the country faces an economic and budget crisis of unprecedented complexity and nearly unprecedented proportions. Major sectors of the economy like housing, autos, and agriculture are in states of depression. Small businesses are going under at rates that we have not experienced since the depression of the 1930's. So many of the financial depository institutions are in serious financial trouble that a collapse of a few big ones could set off a chain reaction that could swamp the FSLIC Insurance network.

Although inflation has plummeted, that relief—so welcome to the eldery—has come at tremendous cost, cost to the economy in terms of lost output, cost to workers in terms of unemployment. What is worse, the relief from inflation may prove to be only temporary. In the meantime, unemployment stands at 8.8 percent as of the end of February and could well go over 10 percent in the near future.

Against the background of an economic landscape strewn with the wreckage of a decade of high and sustained inflation, high interest rates, high unemployment rates, low real GNP growth rates, low and declining rates of gain in productivity and extremely low savings rates, there is the situation of the Federal budget.

All these economic trends have taken their toll on the Federal budget over the years, driving up the cost of Government programs, adding vast numbers of individuals to the benefit rolls, and cutting into the tax receipts that would otherwise have been there to cover the cost of these same programs.

The administration has submitted a budget for fiscal year 1983 that entails a deficit that could be anywhere from $93 billion to $122 billion. The size of the deficit is attributed primarily to the effects of the current recession, the inordinate size of last year's tax cut legislation, and the planned 18 percent increase in spending for defense.

As far as the associations are concerned, we want the Federal budget deficit brought down and the budget ultimately brought into balance. Once that is achieved, we want the balance maintained over the business cycle.

Given the key causes of the deficit situation, the associations believe that a maximum effort has to be made to raise revenue and do it in ways that will not impair recovery from the current recession.

The statement I have submitted for the record outlines a series of revenue raising options. For example, excise taxes on nonnecessities could be raised, substantially. Tax provisions that result in substantial revenue loss could be scaled back or eliminated where the provisions have come to make little or no economic sense, as, for example, the full deductibility of interest payments for consumer installment debt. New taxes or other revenue-raising devices should be implemented where they are consistent with economic

recovery. We think, for example, that the Congress should look seriously at windfall profits taxes on deregulated new natural gas and the imposition of a substantial import fee on foreign imported oil.

A number of the features of last year's tax bill should be eliminated, scaled back, or at least postponed. The revenue losing corporate tax break leasing provisions are a prime example. Another is the windfall profits tax reduction that was a part of last year's tax bill.

With respect to the indexing provisions of last year's legislation, we suggest that, for the present, they either be eliminated or at least made contingent upon the achievement of a balanced budget.

Finally, if all else fails, the Congress should scale back, delay, or perhaps even eliminate the scheduled personal income tax rate reductions, especially the one scheduled for next year.

Some in the Congress say the elderly ought to share the pain that is necessary to get the Federal budget deficit down and the budget under control. Proponents of this view generally offer reductions or limitations in cost of living adjustments in the major entitlement programs as the best way of getting the elderly to share in the pain.

The most prominent COLA cut proposals currently on the table are those advanced by Senators Hollings and Domenici. Basically they call for a freeze on COLAs either this year or next year, followed by a limitation on cost-of-living adjustments equal to the CPI minus 3 percent.

The other major COLA cap proposal currently on the table comes from the CBO. They have called for a limit on cost of living adjustments equal to two-thirds of the change in the price level as measured by the CPI. The associations have consistently opposed delays, limits, and reductions in cost-of-living adjustments in the entitlement programs.

To those who say that the elderly can afford to sacrifice, our answer is that the elderly have indeed sacrificed a great deal over the past decade. Over that period of time, the inflation rate ratcheted upward to record levels, rapidly eroding the purchasing power of many of the private income components that make up much of the elderly's income. At the same time, that same inflation trend robbed them of much of the value of the assets that they accumulated and put aside during their working years to provide themselves with supplementing income during old age.

To those who advocate COLA reductions, we ask that they keep in mind that despite full cost of living adjustments in the entitlement programs in 1979 and 1980, the poverty rate among the elderly jumped from a decade low of 13.9 percent at the end of 1978 to 15.1 percent at the end of 1979, and then to 15.7 percent at the end of 1980.

In order to determine the effect on the elderly of the Hollings-Domenici COLA cut proposals and the CBO two-third cap idea we commissioned a study with the aid of Data Resources, Inc., and an outside private economist. The Washington Post reported the principal findings of that study in last Sunday's edition, but I would like to submit a copy of that brief report for the record of this hearing.

[The information referred to follows:]

THE IMPACT OF PROPOSALS TO MODIFY SOCIAL SECURITY COST-OF-LIVING PROVISIONS ON AGED POVERTY, 1985 AND 1990

SUMMARY

The DRI-AARP Age—Income Model was used to produce computer simulations of the effect on the elderly income distribution of two proposals to modify the cost of living provisions of the social security system. Two proposals were simulated. The first omitted the COLA for 1982 and from 1983 forward, provided benefit adjustments of inflation minus three percent. The second proposal substituted a two-thirds of the increase in the CPI rule, beginning in 1983.

The inflation minus three proposal would result in an additional 1.2 million elderly persons in poverty by 1985 and an additional 2 million persons in poverty by 1990. The two-thirds rule results in an additional 500,000 persons in poverty by 1985 and an additional 1.3 million by 1990. Impacts from either proposal are not uniform within the aged income distribution. This reflects the great variability in the degree to which the aged depend upon social security as a percentage of total income.

INTRODUCTION

This report briefly summarizes the results of a series of computer simulations undertaken to investigate the effect on the elderly income distribution of two proposals to modify the cost of living provisions of the social security system. The two proposals simulated were both under discussion in March 1982. One proposal would omit the cost of living adjustment scheduled for July of 1982 and for future years, would adjust social security benefits by inflation minus 3 percent. The other proposal suggests that the 1982 adjustment occur as scheduled, but from then on, only 66 percent of the measured change in the price level would be added to benefits for inflation adjustments. Although there are a variety of similar proposals, only these two were simulated since they seemed representative of what the Congress was considering as measures to reduce projected federal budget deficits.

The simulations were performed by the Consumer Markets Service of Data Resources Inc., Lexington, Massachusetts, utilizing a computer model developed during the past year for the American Association of Retired Persons, Washington, D.C. This report was prepared by Dr. Thomas C. Borzilleri, a consulting economist for the AARP, who also assisted in the development of the model and directed the specifics of the policy simulations included in this report. Funding for both the development effort and for the policy simulations was provided by AARP. Complete technical documentation of the DRI-AARP Income Model of the Aged is available from AARP upon request.

MODEL OVERVIEW

The starting point for the simulation model is the output of the DRI long-term macroeconomic forecast which is produced each month. The AARP model then takes these forecasted macroeconomic values (interest rates, employment, inflation rates, etc.) and translates them into changes in earnings, interest income, social security income, other transfer income, and other income sources received by the aged population. The changes are then displayed for impacts on the income distribution of four age groups, 55–61, 62–64, 65–71, and 72 and older, for single males, single females and families where the head of the household is in one of the above age groups.

The policy simulations reported here are based on two runs of the system. The baseline simulation, covering the period 1982 thru 1990, was performed in January of 1982.[1] In February of 1982, the model was again run, except instead of assuming full cost of living increases thru 1990, the two proposals discussed above were assumed to go into effect either in 1982 or 1983, depending upon the specifics of each.

Although a great deal of information is produced by the simulation model covering all of the demographic groups referred to above and impacts on six different income classes within each demographic groups, only the impacts on the low income population are reported here. Given the initial baseline simulation and expected poverty for the years 1985 and 1990, the focus of this report is how the number of persons and families with incomes below the poverty line will be altered by each of these two years by the proposed cost of living modifications.

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[1] This report, "The Outlook for the Incomes of the Elderly in the 1980's", prepared by DRI for AARP, is available upon request.

SIMULATION RESULTS

Tables 1 and 2 display the results of the inflation minus three proposals and indicate that implementation would increase the number of persons in poverty in 1985 by 1.2 million persons. By 1990, there would be approximately 2.0 million persons in poverty over what would otherwise be the case. These results simply reflect the fact that at lower income levels, dependency on social security as a percentage of total income is extremely high (75 to 90 percent)[2] and that even small year-to-year erosion can result in significant cumulative income reductions. For example, the three percent proposed erosion, means a 12 percent real social security benefit reduction by 1985 and a 25 percent reduction by 1990. The more heavily dependent upon social security a person is, the more the erosion in social security implies an erosion in total income.

Tables 3 and 4 summarize the results of the 66 percent proposals. By 1985, approximately 500,000 additional persons will have incomes below the poverty level than would be the case with full cost of living adjustments. In 1990, the additional numbers below this level would be approximately 1.3 million.

It should be noted that the assumed *average* inflation rate in the simulation for the 1982–1990 period is 7.5 percent and hence the effective erosion in the two-thirds proposal averages 2.5 percent. To the extent that either the level of inflation or the pattern of inflation is different from that which was forecasted in January by the DRI macroeconomic model, poverty counts will also be different. This is also true of course for any of the simulations undertaken with the DRI-AARP model but it is more crucial with "percentage of inflation" proposals since the effective income erosion rate will vary with the level of inflation.

Tables 5 and 6 display poverty rates by demographic groups within the aged population. It should first be noted that for all groups in the population the impact of inflation minus three is more severe than the 66 percent proposal. Both proposals however significantly increase poverty rates, particularly by 1990.

For example, by 1985 the expected poverty rate with full cost of living adjustments among single women aged 72 or older is 30 percent, with CPI minus 3 it is 37.5 percent, while with the two-thirds proposal it is 33.2 percent. For the same group in 1990, poverty could be expected to decline to 26.1 percent with full COLAs, increase to 38.6 with CPI minus 3 and to 34.3 with the two thirds proposal.

Tables 7 and 8 present the percent changes in poverty rates for the groups in question. For all groups, poverty is expected to decline by both 1985 and 1990 under the full cost of living scenario. Under either of the proposals, there is either an absolute increase in poverty or the decline in the rate is significantly reduced. It should also be noted however, that impacts are far from uniform within the aged population.

TABLE 1.—POLICY SIMULATION: INFLATION MINUS 3 PERCENT FORECASTED POVERTY COUNTS, NUMBER OF PERSONS OR FAMILIES BELOW OFFICIAL POVERTY LINE, 1985

	Full COLA	Proposal	Change
Single men:			
62 to 64	70,854	75,219	4,365
65 to 71	213,988	231,753	17,765
72 plus	230,040	285,250	55,210
Single women:			
62 to 64	192,065	203,410	11,345
65 to 71	803,503	939,267	135,764
72 plus	1,340,850	1,676,063	335,213
Families:			
62 to 64	134,779	158,106	23,327
65 to 71	278,343	407,206	128,863
72 plus	230,206	390,915	160,709
Totals	3,494,628	4,367,139	872,561
Persons (assuming 2 per family)	4,137,956	5,323,416	1,185,460

Source: Simulations produced by DRI-AARP age-income model.

[2] The Distribution of Income and Social Security Benefits within the Aged Social Security Beneficiary Population, 1980, T.C. Borzilleri, March 1982

TABLE 2.—POLICY SIMULATION: INFLATION MINUS 3 PERCENT FORECASTED POVERTY COUNTS, NUMBER OF PERSONS OR FAMILIES BELOW OFFICIAL POVERTY LINE, 1990

	Full COLA	Proposal	Change
Single men:			
62 to 64	56,817	65,163	8,346
65 to 71	170,402	206,917	36,515
72 plus	195,523	293,284	97,761
Single women:			
62 to 64	161,889	181,162	19,273
65 to 71	750,617	1,012,103	261,486
72 plus	1,316,667	1,947,254	630,587
Families:			
62 to 64	108,603	142,390	33,787
65 to 71	240,877	453,746	212,869
72 plus	157,022	420,265	263,243
Totals	3,158,417	4,722,284	1,563,867
Persons (assuming 2 per family)	3,664,919	5,738,685	2,073,766

Source: Simulations produced by DRI-AARP age-income model.

TABLE 3.—POLICY SIMULATION: 66 PERCENT OF CPI FORECASTED POVERTY COUNTS, NUMBER OF PERSONS OR FAMILIES BELOW OFFICIAL POVERTY LINE, 1985

	Full COLA	Proposal	Change
Single men:			
62 to 64	70,854	72,869	2,015
65 to 71	213,988	221,255	7,267
72 plus	230,040	252,533	22,493
Single women:			
62 to 64	192,065	194,740	2,675
65 to 71	803,503	864,458	60,955
72 plus	1,340,850	1,483,874	143,024
Families:			
62 to 64	134,779	142,555	7,776
65 to 71	278,343	329,888	51,545
72 plus	230,206	291,015	60,809
Totals	3,494,628	3,853,187	358,559
Persons (assuming 2 per family)	4,137,956	4,616,645	478,684

Source: Simulations produced by DRI-AARP age-income model.

TABLE 4.—POLICY SIMULATION: 66 PERCENT OF CPI FORECASTED POVERTY COUNTS, NUMBER OF PERSONS OR FAMILIES BELOW OFFICIAL POVERTY LINE, 1990

	Full COLA	Proposal	Change
Single men:			
62 to 64	56,817	62,274	5,457
65 to 71	170,402	194,746	24,344
72 plus	195,523	257,832	62,309

TABLE 4.—POLICY SIMULATION: 66 PERCENT OF CPI FORECASTED POVERTY COUNTS, NUMBER OF PERSONS OR FAMILIES BELOW OFFICIAL POVERTY LINE, 1990—Continued

	Full COLA	Proposal	Change
Single women:			
62 to 64	161,889	174,223	12,334
65 to 71	750,617	929,043	178,426
72 plus	1,316,667	1,730,332	413,665
Families:			
62 to 64	108,603	130,324	21,721
65 to 71	240,877	369,719	128,842
72 plus	157,022	314,044	157,022
Totals	3,158,417	4,162,537	1,004,120
Persons (assuming 2 per family)	3,664,919	4,976,624	1,311,705

Source: Simulations produced by DRI-AARP age-income model.

TABLE 5.—POVERTY RATES BY DEMOGRAPHIC GROUP

	1980	1985		
		Full COLA	CPI–3	.66 CPI
Single men:				
62 to 64	21.3	21.1	22.4	21.7
65 to 71	28.6	26.5	28.7	27.4
72 plus	25.5	22.5	27.9	24.7
Single women:				
62 to 64	24.3	23.7	25.1	24.3
65 to 71	31.5	29.0	33.9	31.2
72 plus	34.4	30.0	37.5	33.2
Families:				
62 to 64	5.4	5.2	6.1	5.5
65 to 71	5.8	5.4	7.9	6.4
72 plus	6.4	5.3	9.0	6.7

Source: Simulations produced by DRI-AARP age-income model.

TABLE 6.—POVERTY RATES BY DEMOGRAPHIC GROUP

	1980	1990		
		Full COLA	CPI–3	.66 CPI
Single men:				
62 to 64	21.3	17.7	20.3	19.4
65 to 71	28.6	19.6	23.8	22.4
72 plus	25.5	18.2	27.3	24.0
Single women:				
62 to 64	24.3	21.0	23.5	22.6
65 to 71	31.5	24.4	32.9	30.2
72 plus	34.4	26.1	38.6	34.3
Families:				
62 to 64	5.4	4.5	5.9	5.4
65 to 71	5.8	4.3	8.1	6.6
72 plus	6.4	3.4	9.1	6.8

Source: Simulations produced by DRI-AARP age-income model.

TABLE 7.—PERCENT CHANGES IN POVERTY RATES, 1980–85

	Full COLA	CPI–3	.66 CPI
Single men:			
62 to 64	−0.9	+5.2	+1.9
65 to 71	−7.3	+.3	−4.2
72 plus	−11.8	+9.4	−3.1
Single women:			
62 to 64	−2.5	+3.3	0
65 to 71	−7.9	+7.6	−.9
72 plus	−12.8	+9.0	−3.5
Families:			
62 to 64	−3.7	+13.0	+1.9
65 to 71	−6.9	+36.2	+10.3
72 plus	−5.6	+40.6	+4.7

Source: Simulations produced by DRI-AARP age-income model.

TABLE 8.—PERCENT CHANGE IN POVERTY RATES, 1980–90

	Full COLA	CPI–3	.66 CPI
Single men:			
62 to 64	−16.9	−4.7	−8.9
65 to 71	−31.5	−16.8	−21.7
72 plus	−28.6	+7.1	−5.9
Single women:			
62 to 64	−13.6	−3.3	−7.0
65 to 71	−22.5	+4.4	−4.1
72 plus	−24.1	+12.2	−0.3
Families:			
62 to 46	−16.6	+9.3	
65 to 71	−25.9	+39.7	+13.8
72 plus	−46.9	+42.2	+6.2

Source: Simulations produced by DRI-AARP age-income model.

Mr. HACKING. In summary, the effect of the Hollings-Domenici proposals would be to add 1,200,000 additional elderly people to the poverty category by 1985 and 2 million by 1990. The effect of the CBO two-thirds cap proposal would be an additional half-million elderly in poverty by 1985 and 1.3 million by 1990.

For some of the subgroups among the elderly, the situation would be far worse. For example, the effect of the Hollings-Domenici proposals would add 630,000 single women aged 72 and older to the poverty ranks by 1990. The incidence of poverty among that subgroup of elderly by that time would be nearly 40 percent.

In conclusion, Mr. Chairman, I reiterate that the associations want the Federal budget deficits reduced and the budget brought into balance, but given the current situation, we think there is no reasonable option left to the Congress other than to look primarily to the revenue side of the budget to bring those deficits down—put them on the down slope—and get the Government out of the credit markets so that it does not end up competing against private business and driving up interest rates when an economic recovery begins.

That concludes my statement, Mr. Chairman. I thank you for having had this opportunity.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS

I. OVERVIEW OF THE ECONOMY AND THE BUDGET

The deficits projected in the near term are resulting from the current intense recession, last year's huge and ill-targeted tax cuts and the large increases planned for defense spending. Reducing the deficit and making progress toward a balanced budget is critical to the economy for several reasons.

First, large and continuing deficits are viewed by both the public and by business as inflationary. This has created an environment that is not only likely to stimulate the wage/price spiral but also dampen incentives to save and invest on the part of individuals and business. The passage of last year's Economic Recovery Tax Act has not brought about any significant dampening of the public's expectations for continued inflation and has not generated the savings and investment necessary to promote recovery and long-term economic expansion.

Second, given the Federal Reserve's tight money policy (which unfortunately has been the only effective anti-inflation program in town), large deficits will lead to soaring interest rates, making it extremely difficult for the economy to recover from the current recession. At best the result will be either stagflation or a weak recovery followed by another recession.

Lenders are demanding high interest rates out of fear that inflation will remain elevated and resurge with any recovery, no matter how modest. Uncertainty has gripped the financial markets, creating havoc and preventing the long-term investment which the economy needs. While the current recession may be bottoming out, the high unemployment and business disorder give rise to fears that the recession could deepen even further during the coming months. At present, there are simply no reliable signs that a recovery is under way. The high interest rates and tight money conditions, which precipitated the present recession, will remain with us until the deficit is brought down.

With respect to defense spending, we know of no instance of deficit financing of defense expenditures that did not prove to be inflationary. National currencies in such circumstances tend sooner or later to be destroyed. The threat to the U. S. dollar that results from opting for deficit financing to accommodate increased defense expenditures only tends to reinforce the public's and the financial market's pre-existing expectation that inflation will be renewed—and perhaps with such a vengeance that it will climb to levels higher than any previously experienced.

The economic outlook is bleak. One of our most important industries, automobiles, is best described as "on the ropes", along with our major agricultural implement manufacturers. Housing construction is at a virtual standstill. The savings and loan industry which supports home construction, is in grave financial circumstances. Bankruptcy statistics of small and medium firms have been approaching depression levels. Unemployment, now close to 9 percent, may go as high as 10 percent. Unemployment in many of our snowbelt industrial cities has been rising towards levels not seen since the Great Depression of the 1930s.

The leading indicators turned downward in January, pointing toward a continuing reduction in business activity. In fact, January marked the ninth consecutive month of decline for the index. The stock market has recently dropped to new lows and the term "depression" has reentered our economic vocabulary.

Administration spokesmen are still predicting an explosion in savings rates followed by a great flow of funds into new investment. We would be very happy to see this, but there are no advance indications of such financial developments. How can a depressed economy, irrespective of the lowering of marginal tax rates, generate enough personal income to boost savings? Corporate profits and corporate cash flows have been tepid. Surveys of the plans of business for capital investment show that it is doubtful that capital outlays, after correction for inflation, will be any greater in 1982 than they were in 1981.

In August, the Administration declared that once all of their economic program was in place, public expectations of continuing inflation would diminish, interest rates would decline, and there would be a rush of investment and innovative enterprise. This has not happened and there is no good basis for believing that it will in the near future. Revising the Administration's FY 1983 Budget so that the deficits start coming down would do much to bolster public confidence in the economy in the coming months.

The recession has been virulent enough to bring about some reduction in interest rates, but they remain astonishingly high when compared to current inflation rates. We have had some temporary relief from inflation; by January 1982, the three-

month annual rate of change for the CPI-U was only 4.8 percent. The tight money policies of the Federal Reserve Board have substantially contributed to lowering inflation rates along with an additional measure of relief from the relative stability of crude oil prices. The abundant grain crop in 1981 also contributed in important ways to slowing inflation rates.

We are most thankful that inflation rates have come down. Unfortunately, the public, and those with money to lend, simply do not see inflation remaining at low rates. Deficit projections that run as much as 50 percent higher than the Administration's projections, frighten potential lenders all the more. The dangers of depression or, more likely, the dangers of a recession lasting for months to come, are attributable to continuing high interest rates caused by massive deficits in the projected federal budgets.

The only way to dampen these fears is for either the Administration to submit a new budget to Congress with a believable program for bringing the budget into balance or for Congress to develop its own. Credibility must be restored to our economic programs. For some weeks now, the Administration has been working on the theme that deficits do not matter that much; they are an unavoidable part of the current economic landscape. Unfortunately, the American public firmly believes that federal budgetary deficits are a prime cause of inflation—ironically, a view which the current Administration fostered.

Deficits do matter, not only because the public believes that they do but because they tend to inflate the money supply and because they cause the government to monopolize the national pool of savings.

II. THE ELDERLY'S ERODING POSITION IN THE ECONOMY

The nation faces a federal budget crises of unprecedented proportions. Annual deficits far in excess of $100 billion are being projected for each of the next three years, pushing reasonable prospects for a balanced budget out of the foreseeable future. These looming deficits are bad for the economy and, furthermore, directly threaten the already deteriorating economic position of the elderly. The Associations hope the Congress will move to revise the Administration's FY '83 budget. A budget impasse is something we must avoid. The consequences for the economy at large and for the elderly in particular would be disastrous.

This Committee, with its jurisdiction over tax policy and the basic entitlement programs serving the elderly, bears a heavy responsibility for pursuing a deficit reduction strategy that, for the benefit of all Americans, will begin to move the budget into balance. This strategy, however must be pursued in a manner that recognizes that a decade of inflation has forced the elderly into an extremely vulnerable economic position—a position in which they find themselves heavily dependent on government entitlement programs for the bulk of their income support. This Committee must realize that the immediate consequences of large-scale cutbacks in programs, such as social security, Medicare and Medicaid, will be even greater increases in the elderly poverty rate than we are already experiencing and a more rapid deterioration in their subsistence-level standards of living.

In the past few weeks, we have witnessed a veritable flood of budget proposals and alternatives. Regardless of the specifics of each, the essence of their message is readily apparent: large, escalating deficits are not acceptable. What *is* acceptable is, of course, more difficult to determine.

Realistically, no Member of Congress nor any constituency group is likely to be entirely happy with what is devised. We recognize that the elderly are not likely to be completely spared some measure of pain—even though they have suffered much more than their fair share already. What we are seeking—and what we hope the members of this Committee are seeking—is a fair and balanced package which makes good economic sense by making a maximum effort to raise revenue and cut back expenditures in areas and in ways that do not do damage to program benefits of vital importance to lower income groups—especially the elderly. Cuts—particularly those in basic entitlement programs—would drastically undermine the economic situation of the elderly and leave them even more vulnerable than they already are to the escalating costs of health care and to inflation in general. At this time, it is safe to say, none of the alternative budget packages currently "on the table" meet the test of fairness and economic soundness that we have in mind.

In 1980, Data Resources, Inc. (DRI) completed a study for our Associations on "Inflation and the Elderly." That study found that the average elderly incomes (in aggregate terms) managed to slightly exceed the general rate of inflation from the late 1960's through the late 1970's. Consequently, by 1978, the average income of those over age 65 was about 55 percent of the average incomes of the non-elderly. This

progress resulted from the deliberate expansion of government programs, especially social security, in recognition of the extremely high (25–30%) elderly poverty rates prevailing at that time. Also, the creation of Medicare, Medicaid and SSI helped a great deal to improve the elderly's economic status.

Despite progress made in raising the elderly's average income levels and reducing poverty among them, there is mounting evidence that inflation has begun to wipe away that progress. Elderly poverty rates, on a steady decline through 1978, increased from 13.9 percent in 1978 to 15.1 percent in 1979 and again in 1980 to 15.7%—the largest increase in the elderly poverty rate since the Census Bureau began collecting such data and the highest poverty rate of any adult age group. We believe that the fixed nature of the elderly's income components as well as their inflexible consumption patterns—particularly for food, fuel and medical care—are largely responsible for the substantial increase in the elderly poverty rate.

Moreover, despite the limited growth in the elderly's income during the period 1968–1978, the continuing escalation of the elderly's poverty rate and other statistics demonstrate the disadvantaged position of the elderly relative to the rest of the population. For example, in 1980, while only 9 percent of non-elderly households had annual incomes below $5,000, 26 percent of elderly households had annual incomes below $5,000. Similarly, only 20 percent of non-elderly head-of-households had annual incomes under $10,000, while 56 percent of the elderly head-of-households had incomes in that category. Even adding to their income the cash value of the in-kind benefits the elderly receive does not change the reality that the elderly, as a group, generally subsist on low and in many cases wholly inadequate incomes. In 1980, over half of all individuals age 65 and above—more than 13 million people—had an average annual income of less than $5,000.

III. REVENUE RAISING PROPOSALS AND THE UNACCEPTABILITY OF THE WITHHOLDING ON INTEREST AND DIVIDENDS PROVISION

The Associations support the efforts of the Administration, in its Budget proposal, to raise revenues. It is our belief that all possible means of raising revenue should be analyzed as possible means for constricting projected deficits in ways that would not jeopardize economic recovery. We regret, however, that the Administration did not go very far at all in suggesting revenue producing measures. To this end, in Section IV of this testimony, we suggest alternatives not contained in the Administration's budget package.

With respect to the Administration's proposal to introduce withholding for interest and dividend income, we must take strong exception. While the underlying reasons appear sound—to counter non-compliance problems and, in the process, to raise revenue—we feel this proposal could create problems for many of the elderly. Even though the proposal contains an exemption for persons 65 or older, many of these people will suddenly find themselves having to file for one or more exemptions, since many elderly persons receive dividend and interest income from several sources. The exemption certificate represents a departure from longstanding tax collection rules with which the elderly are currently familiar. As a result, many of the nation's elderly, because of this unfamiliarity, poor health, or other reasons, may never receive the exemption to which they are entitled.

Additionally, the elderly, who require a steady stream of interest and dividend income to provide for basic living expenses, will lose a significant portion of this income. This would be due to the loss of such income during the year or as the result of the loss of compounded interest on funds remaining in a savings account.

Such a proposal would place new burdens on the payor institutions—additional paperwork, explanation time, computer time, etc. These new burdens might well be passed on to the saver and investor. Since savers have already lost much to inflation, we believe that this is a particularly inopportune time to implement a new policy that causes even inadvertent losses on income from savings.

IV. THE NEED TO RAISE REVENUES

Since the Administration plan does not go far enough in its consideration of revenue producing measures, we urge the Committee to seriously consider the following proposals. We feel that to protect the economy and the well-being of the elderly, the budget deficit must be reduced in manner that is consistent with the goal of achieving economic recovery and will reduce the mounting pressure to cut entitlements. To do this, the Associations believe that revenues must be increased. As a first step, we feel that Congress should take a careful look at the tax code to remove tax expenditures that may no longer make economic sense. Also, new taxes may have to be implemented and existing ones raised. Finally, if these measures do not raise a

sufficient amount of revenue, portions of the Economic Recovery Tax Act of 1981 should be scaled back or even repealed.

The following provisions do not cover all revenue-raising possibilities. However, the Associations offer them as an indication that significant revenue can be raised without jeopardizing economic recovery. In fact, we believe that measures such as these are absolutely essential if economic recovery is to occur at all.

1. Repeal Tax Expenditures if their Costs Outweigh Their Economic Usefulness:

Changing economic circumstances make it imperative for Congress to periodically review tax expenditures (i.e., tax provisions that cause revenue loss) to determine their expense and their value. If Congress can control the growth of tax expenditures, it will take a major step toward stabilizing the federal budget.

(a) According to the Congressional Budget Office [1] a repeal of certain oil and gas industry tax expenditures could raise $10 billion in fiscal year 1984. $1.6 billion can be gained by repeal of the percentage depletion allowance, which is a write-off of 18 percent (in 1982) of the gross income (up to a limit) from select oil and gas wells. This method often allows the well owner to recover much more than the cost of extraction. Additionally, $8.4 billion can be raised by repeal of the expensing provision for intangible oil and gas drilling costs. This would allow certain oil and gas drilling costs to be written off in the year they occurred rather than adopting the general approach of depreciating these costs over a period of years. Given the major restructuring of the corporate income tax that was a part of the Economic Recovery Tax Act of 1981 and the rapid increase in energy prices, these incentives to produce may no longer be necessary.

(b) The deductibility of consumer interest payments will cost $7.8 billion in fiscal year 1984. Because of the increasing need to encourage people to save and invest, this tax expenditure may be counterproductive. Also, the tax break is available only to persons who itemize their deductions in computing their income tax liability.

2. Portions of the Economic Recovery Tax Act of 1981 can be modified without harming the Act's intent:

(a) The corporate "leasing" provisions will cost about $4 billion in FY 1983. If leasing is felt to be desirable, Congress should at least structure the law to limit its applicability.

(b) Repeal of the Windfall Profits Tax reductions would save $1.7 billion in fiscal year 1983 and $2.2 billion in fiscal year 1984. The Windfall Profits Tax provisions include an exemption for some royalty owners, reduced rates for certain oil of independent producers, a reduced rate on newly discovered oil and an exemption for oil rights owned by qualified charities that care for children (the last item has a very small revenue loss figure). Source: Joint Committee on Taxation Summary of H.R. 4242.

3. New or increased taxes which are consistent with an economic recovery program should be implemented:

(a) A windfall profits tax on deregulated natural gas could raise up to $12 billion in fiscal year 1984 if decontrol were moved ahead to January 1, 1983.

(b) Doubling the liquor tax will raise $3.5 billion in FY 1984.

(c) Doubling the excise tax on beer and wine will raise $1.3 billion in FY 1984.

(d) Doubling the cigarette tax will raise $1.8 billion in FY 1984.

The taxes discussed in proposals (b)–(d) were last raised in 1951.

4. The indexing of the income tax brackets, the zero bracket amount and the personal exemption that is due to begin in 1985 should be repealed or delayed until economic conditions improve:

The Associations realize that bracket creep due to inflation has increased the tax burdens of workers. However, the existence of the indexing feature in 1985 builds revenue losses into the future on top of massive deficits. The future deficit projections are creating havoc with the credit markets. We feel the federal budget should be brought into balance before any indexing of major features of the code is introduced.

5. If the deficit reduction measures listed above (along with others Congress may choose) are insufficient, the personal tax rate reductions that are included in the Economic Recovery Tax Act should be postponed or scaled back or even repealed:

While we believe that this should be a last resort for Congress, a postponement of the rate cuts may be needed to improve the deficit situation. A postponement of the July 1983 ten percent cut will save $27 billion in FY 1984.

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[1] Unless otherwise stated, the revenue figures can be obtained in the Congressional Budget Offices' Report to the Senate and House Committees on the Budget, Part III: Reducing the Federal Deficit: Strategies and Options. February 1982.

During the debate on the tax bill the Associations had urged that the size of the tax cut not exceed the reduction achieved in government spending. This would have assured a balanced budget by 1984. In addition, the Associations took the position that the tax cut should have been specifically targeted to encourage and reward saving and investment so as to strengthen productivity growth and help revitalize the economy.

In addition to considering the foregoing, we urge the Committee to explore other feasible methods of raising revenue, including consideration of an oil import fee as well as a gasoline tax increase. If instituted now, either of these measures would take advantage of the current decline in world oil prices in an effort to raise badly needed revenues. In addition, they would serve to maintain the nation's current conservation efforts. On the other hand, such measures would prevent a gasoline and other oil product price decline from benefiting consumers.

The oil import fee, while generating revenue, would encourage domestic production because the price of domestically produced oil tends to be "pegged" to the same level as imported oil. Moreover, the imposition of such a fee would not directly enter into the computation of the CPI.

Conversely, such an oil import fee would indirectly affect the CPI by preventing or reducing the decline that might otherwise take place. In addition, such a fee would increase all oil and oil derivative prices, including the cost of home heating oil, not just gasoline prices.

An excise tax on gasoline, which would be a direct tax on both domestic and foreign gasoline would certainly generate significant revenue. In addition, the tax at the pump would extend only to gasoline, and would not affect other petroleum products such as home heating oil. On the other hand a tax on gasoline would increase the CPI directly since the index includes taxes. With no distinction being made at the pump between domestic and foreign gasoline, there would not be an incentive for domestic producers such as an oil import fee would afford. Finally, such a tax, at the federal level might preempt the states which have in increasing numbers been raising their own excise taxes on gasoline in an effort to increase state revenues.

The Associations would welcome the opportunity to comment further on the oil import fee and/or the gasoline excise tax options should such options be formally advanced. Additionally, we would like the opportunity to comment upon any other revenue raising measures that may come before this Committee for consideration.

V. TAXPAYER COMPLIANCE

To address the growing problem of a lack of taxpayer compliance, Senators Dole and Grassley and Congressman Conable have introduced the Taxpayer Compliance Improvement Act of 1982 (S. 2198 and H.R. 5829). Senator Dole estimates that this measure will increase federal revenues by $3 billion in FY 1983 and $8.1 billion in FY 1984.

The Associations generally support the effort to encourage taxpayers to pay their tax bills. The components of the legislation include: improved information reporting, additional penalties and interest charges for people who pay late or fail to make their proper payments, increased IRS funding which would lead to improved enforcement, and automatic withholding on annuities unless the taxpayer opts out of the withholding process.

While we can support all of these measures except automatic withholding for annuity income (i.e., withholding should remain at the discretion of the taxpayer), we are particularly pleased that this legislation attempts to handle the nonreporting of interest and dividend problem without immediately resorting to automatic withholding. As we state elsewhere in this testimony, interest and dividend withholding could create many complications. We certainly prefer this effort to strengthen the voluntary approach to any automatic withholding on interest and dividend income.

VI. CONCLUSION

The nation faces a federal budget crisis of unprecedented proportions. This Committee, with its jurisdiction over tax policy, revenue producing measures, and the basic entitlement programs serving the elderly, bears a heavy responsibility for pursuing a deficit reduction strategy that, for the benefit of all Americans, will begin to move the budget into balance. This strategy, however, must be pursued in a manner that recognizes that a decade of inflation has forced the elderly into a position in which they find themselves, through no fault of their own, heavily dependent on government entitlement programs for the bulk of their income support. The immediate consequences of large-scale cutbacks in programs like social security, Medicare and Medicaid will be even greater increases in the elderly poverty rate than we are

already experiencing and a more rapid deterioration in their subsistence-level standards of living. Therefore, we strongly support the efforts of this Committee to come up with suitable revenue producing measures in the hope that the basic entitlement programs will continue to serve the elderly.

What we are seeking is a fair and balanced package which makes good economic sense by making a maximum effort to raise revenue and cut back expenditures in areas that do not do damage to program benefits of vital importance to lower income persons or to the elderly.

Mr. GIBBONS. Thank you, Mr. Hacking.

The next witness on our list is Dr. Albertine.

STATEMENT OF JOHN M. ALBERTINE, PRESIDENT, AMERICAN BUSINESS CONFERENCE, INC.

Mr. ALBERTINE. Thank you, Mr. Chairman.

My name is Jack Albertine. I am president of the American Business Conference. The American Business Conference is a relatively new organization limited to the chief executive officers of 100 of America's most energetic and successful firms. These firms have annual revenues between $25 million and $1 billion, and each has doubled in size over the last 5 years.

They are located in all regions of the country and they represent the full spectrum of American commerce.

I would like to just give you a statistic or two about our organization. Over the last 3 years, American Business Conference companies created on average about 40 percent more jobs than the top 10 performers of the Fortune 100.

Over the last 3 years, the American Business Conference firms had average sales growth rates of about 33 percent faster than the 10 best performers of the Fortune 100. Over the last 3 years, the growth of average earnings per share of American Business Conference companies was also about 33 percent faster than that of the top 10 performers of the Fortune 100.

The successful entrepreneurs who comprise the membership of the American Business Conference came to Washington 2 weeks ago to discuss their perspectives on the state of the economy. At the end of the 2 days, the CEO's vigorously reaffirmed their support for the Reagan economic program.

Mr. Chairman, the Reagan economic program signaled a dramatic turnaround in the design of our tax structure. Previously the goal was to use a graduated income tax system to gradually equalize the after-tax income of all Americans. The income and equality produced by the play of the marketplace was to be rectified by the tax and spending actions of the Federal Government.

The long-term result of this myopic and archaic economic philosophy was that investment was discouraged, thrift was thwarted, and production was penalized. The President's program has sought to invigorate our economy by restoring incentives for work, savings, and investment.

The American Business Conference believes that the President should stick with his basic economic program which seeks to shift resources from the public to the private sector where they can be utilized to increase jobs, production, and revenue; to encourage savings and investment through tax reduction; to reform the Federal

regulatory apparatus; and to provide a consistent set of economic policies on which the business community can plan.

The Reagan economic program seeks to reverse the trend of increasing Federal spending and taxation which was slowly strangling the American economy. It seeks to restore the incentive structure of the American economy through across-the-board multiyear personal tax reductions.

The Reagan plan is designed to revitalize the economy by rewarding risk takers, stimulating savings, and encouraging investment.

Even the projected Federal deficits have at least one concealed virtue. They are forcing Republicans and Democrats on Capitol Hill to remove the haloes from a whole herd of sacred cows and to consider at last culling from the herd, beasts that have been untouchable for years.

When the Reagan administration took office the basic problem with our economy was not just the combination of inflation, high interest rates, and an exponentially expanding public sector; it was also the paralyzing decline in our productivity growth. This decline was making our economy uncompetitive in world markets and threatening the United States with long-term economic stagnation.

It is this long-term problem which the Reagan program is addressing when it attempts to cut spending at the same time it cuts taxes. The private sector utilizes resources more efficiently than the public sector, so shifting resources back to the private sector improves our Nation's productivity performance. Only an improvement in our productivity performance can raise the standard of living of the average American.

Mr. Chairman, it is important for this committee to remember that even if we reduce our inflation rate to zero, our standard of living will decline if productivity growth remains in the doldrums.

Mr. Chairman, I do not want to give the impression that the American Business Conference is unconcerned about the size of the current and future projected deficits. Frankly, our members would like to see some additional spending cuts. We think our defense capability can be made second to none with somewhat smaller increases in defense spending than are projected by the administration.

We believe that benefits from the entitlement programs cannot continue to increase faster than the pool of revenues which finance these benefits. We think that domestic discretionary spending should be carefully examined and perhaps some cuts should be made. Funds for some programs such as student loans in technical fields should perhaps be restored while other untouched benefit programs should bear their share of the cuts.

On the revenue side, the American Business Conference believes it is best not to defer, postpone, or tamper with the third year of the individual tax reduction. No one can predict our economic circumstances a year from now, and I believe we should send a signal of consistency rather than change to the financial markets.

In fact, it might be a good idea to move up the starting date of the second year cuts so as to achieve additional stimulus now. Marginal tax rate reductions for individuals are the key to reversing the erosion of the incentive structure of the American economy.

Restoration of that incentive structure is the key to the capacity of this economy to sustain a high rate of growth over the long term.

The American Business Conference continues to believe that Federal deficits will not decline significantly without a strong economy and that a strong economy is predicated upon the absence of disincentives to economy revitalization.

Mr. Chairman, our members know that a compromise budget will have to include three elements if it is going to be acceptable to all parties: Moderation in defense spending increases, reductions in entitlement programs, and some tax increases.

The chief executive officers of the American Business Conference passed, I think, a rather remarkable resolution regarding the revenue side of the ledger. Our members have voted to urge the administration and the Congress to examine all corporate tax benefits in the search for additional sources of revenue if that is necessary for a comprehensive budget to be enacted by this Congress. Specifically, they recommended that Congress repeal the safe-harbor leasing provisions enacted last year.

Mr. Chairman, when was the last time a business organization suggested that corporate tax relief is expendable while individual tax reduction is not?

In closing, I would like to reaffirm the support of the American Business Conference for the President's overall economic program. It is a comprehensive plan to get us off the shoulder of the economic highway and back into the fast lane where we belong.

Thank you very much.

Mr. GIBBONS. Thank you.

Our next witness is Dr. William Barth.

STATEMENT OF WILLIAM D. BARTH, DIRECTOR, SMALL BUSINESS PRACTICE, ARTHUR ANDERSEN & CO., ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Mr. BARTH. Mr. Chairman and members of the committee, my name is William Barth. I am the director of the small business practice of Arthur Andersen & Co. This testimony today is given on behalf of the National Small Business Association, a multi-industry trade association which has grown to about 50,000 small businesses nationwide.

During the past 2 or 3 years, I have been privileged to appear before several committees of the House, and I thank you for asking me back today.

As a preface to my comments may I state that small business applauds all reasonable efforts to bring government revenues and expenditures in line with each other. We are concerned that large deficits must be covered by additional borrowing, and we will all be chasing the same dollars.

As you know, small business is dependent upon credit and borrowing. Interest rates are strangling us today and we are concerned that continued high deficits will only serve to extend the problem that we have.

I need not recite to you statistics on the importance of small business, on the jobs that it creates, on the innovation that it devel-

ops, on its production and productivity. From time to time we see rays of hope that there is a growing recognition that small business has unique problems and it is presently struggling for survival.

Secretary Regan noted the possible need for small business exemptions to proposed legislation just 6 weeks ago. However, the summary language in the budget proposals does not reflect this. So today I would like to talk to you very informally on two technical aspects of great interest to small business.

I found some of this discussion this morning rather academic and rather boring to one who represents the small business community. You do not save taxes if you are not paying taxes, and that represents a good part of the small businesses, around the country. So let's talk about some other things.

Last Thursday when I received notice of today's hearings, I was seated in the office of Mr. John Philips, who is the president of Lilliston Co. This is a second generation business located in Albany, Ga.

I said to Mr. Philips, "Wasn't your new building financed by industrial development bonds?" and he said, "Yes."

I said, "Well, how much did you spend for it, how much were the bonds?" He said, "They were $2 million."

I asked, "Would you have built the building without those bonds?" The answer was "No; we could not afford to pay current interest rates to construct that building were it not for the availability of industrial development bonds."

These bonds were issued by the county. I believe it was Lee County, Ga. The bonds bear interest at 8.5 percent, so $2 million of 8.5 percent bonds amounts to $170,000 a year of interest. Now, that interest is tax free to the recipients. If those recipients are in the maximum tax bracket of 50 percent, that would mean the loss of revenue is $85,000.

Theoretically, we are losing $85,000 to have that $2 million bond issue outstanding, but what has it brought about? We have 100 people working in that building manufacturing farm equipment which will be sold to the peanut farmers in Georgia, to the wheat growers in the great plains, and exported to Canada—100 new jobs.

We have been told several times that the annual cost to the government of an unemployed worker is $25,000. If you multiply that $25,000 times 100 people, it tells us that at a cost of $85,000, we are saving $2.5 million. On the plane this morning I figured that to be a return of 29 to 1. That is a pretty good return.

I thought perhaps that ratio is a little high, so let's probe further. Yesterday I met with Mayor Norris of St. Charles, Ill., a small town in the fringes of the Chicago metropolitan area. We talked about three new plants that are in the process of construction. Each of those plants would not have been built, according to Mayor Norris, were it not for the availability of industrial development bonds. Those bonds for those three plants aggregated $7 million. The maximum loss of tax revenues on the interest alone, according to my computation, is $300,000.

Those three plants have provided 150 jobs, and using the same formula as before, we have saved $3,750,000. Now, I grant you that is a return of only 12 to 1, but it is not a bad return.

The administration's proposal would permit small issue industrial development bonds but with conditions. These conditions would impose new redtape, and what it giveth with one hand, it taketh away with the other because it taketh away the ACRS opportunities; so where are we? We are right back to where we started from. It would require using straightline depreciation for that new facility.

I would urge you that in view of the great difficulty which small business is having in securing capital, this issue stands out among all others as the saviour for the small company that wants to grow and create new jobs.

The second issue I would like to address is the completed contract method of accounting. I do not know of any industry that is surrounded by more uncertainties than contractors. They have uncertainties in the quality of material that they have purchased to put into the product.

They have variables in the efficiency of labor. They have weather to contend with, and nearly every product they produce is a specially constructed item. Construction is not produced in the back of a plant by a stamping machine that creates products—there you can use a stopwatch and determine that every 10 seconds there will be x pieces produced. That is not the way of construction.

The completed contract method, which we have used since 1917 or 1918, avoids trying to evaluate uncertainties and make assumptions on what may or may not occur in the future. Small business contracts typically are not big, long contracts. I have rarely seen a contract a small businessman can handle running longer than 2 or 3 years at most. It is very, very difficult to determine the stage of completion of a contract. As a practicing auditor, I can assure you it is one of the greatest headaches we have when we are reviewing the financial statements of our clients. The recordkeeping that would be involved by use of methods other than the completed contract would add considerably to the recordkeeping burdens of small business.

The bottom line is that if completed contract method is not acceptable, small business would be reporting its taxable income on the basis of estimates and assumptions. The small businessman typically does not have the office personnel nor the sophisticated reporting procedures to do this.

Gentlemen, I thank you very, very much for your time.

[The prepared statement follows:]

STATEMENT OF WILLIAM D. BARTH ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Good morning. My name is William D. Barth and I am Director of Small Business Practice for Arthur Andersen & Co. This testimony is in behalf of the National Small Business Association (NSB), a muti-industry trade association founded in 1937 which has grown to include about 50,000 small businesses nation-wide. I was privileged to appear before House Committees several times during 1981 on the Administration's tax proposals, and we appreciate being invited back to comment on the 1982 round of these proposals.

Contained in the Administration's budget for fiscal year 1983 (beginning October 1, 1982) there are 25 revenue raising proposals classified under four headings: "Selected Tax Revisions," "Improved Tax Collection and Enforcement," "Other Management Initiatives," and "User Fees."

The revenue increases proposed by the Administration are summarized in the following table according to these categories:

PROPOSED REVENUE INCREASES BEGINNING IN FISCAL YEAR 1983

[In billions of dollars]

	Fiscal year 1983	Fiscal years 1983–87
Selected Tax Revisions	7.2	65.8
Improved Tax Collection and Enforcement	5.5	21.0
Other Management Initiatives	12.4	64.5
User Fees	2.5	18.3
Totals	27.6	169.6

These proposals are designed to raise $27.6 billion in new 1983 revenue and an average of about $34 billion per year for 1983–87 period. The grand total of $169.6 for the five years would constitute one-half of the amounts ear-marked by the Administration to reduce the deficits during this period. A listing of each of the 25 proposals, compiled by the National Journal Magazine is attached to our testimony as an Exhibit.

We can offer the committee our tentative impressions of the small business impact of the tax revisions on the basis of the brief descriptions set forth in the Administration's budget of February 8, 1982.

During the formative period, we noted several rays of hope for small business. In the Daily Tax Report (Bureau of National Affairs, February 11, 1982, page G–3), Treasury Secretary Regan was reported as expressing a willingness to consider "small business exemptions" on the completed contract and withholding provisions. However, the summary language in the budget proposals does not yet reflect such exclusions. ("Receipts Proposals," Budget of the United States Government, Fiscal Year 1983, Section 4–11).

The budget documents did, however, offer hope that the industrial revenue bond matter would be resolved favorably for small business, by stating that "small issue industrial development bonds will not be allowed for large businesses."

A follow-through toward such reasonable and consistent small business considerations for the 1983 provisions would be a happy ending to this chapter of the story. That could make it very much in order to commend the Administration for such small business considerations recognizing the special character of smaller enterprises, and thus averting problems which might otherwise have arisen for small business and the economy.

SMALL BUSINESS ASPECTS OF THE TAX REVISIONS

A brief review of the major tax revisions follows:

Completed contract method of accounting. The "completed contract" procedures the Administration proposes to eliminate would adversely impact some small businesses as well as large business. Although there are alternative accounting measures available, any change would be more burdensome for smaller firms. Accordingly, the concept of a small business exemption proposed by the Secretary of the Treasury makes good sense to us.

Our first impression was that a $100,000 exemption consistent with the graduated corporate tax schedule would be in order. However, on investigation we find that the size of even modest contracts is well above that threshold.

Further, small companies are not usually awarded the long-term contracts—over 3 years—which are the subject of concern in this area.

The accounting burdens of switching from a completed contract to a method such as "percentage of completion" is technically and financially significant.

For these reasons, we would favor an exemption based on the size of the business and/or the size of the contract which are realistically matched to economic conditions for the purpose of excluding small business from the provision.

Business Energy Tax Credits. From the Administration's rationale for this change, it appears to be a perfect place for an equivalent small business exemption.

The Administration's argument is that "with decontrol of oil and natural gas prices, businesses no longer need additional investment incentives for energy conservation and the development of alternative energy sources."

However, this overlooks the serious capital formation problems created for small firms by the past and future surges in energy prices. Small enterprises are much less able to bear the extra costs of operation of higher fuel prices. When such firms attempt to go further and raise enough capital for investments to reduce energy use, they are shouldering a double financial burden.

Millions of our business structures presently in use were erected during the era of energy abundance. They must be retro-fitted by their small business owners in order to be energy efficient. Energy tax credits are not only "incentives," they are vital for capital formation, because the bankers considering the financing of these improvements can count on quicker recovery of the investment and therefore quicker repayment.

The three year total of revenues involved in the full elimination of the energy provision is $1.1 billion. So, the cost of preserving it on a transitional basis would be minor and the benefits would be very great in terms of energy conserved, jobs maintained, business and community stability and national economic strength.

Tax exempt revenue bonds for private activities. Although IRBs were first issued in the 1930s, their use expanded slowly and it was not until their reported issuance reached $1.8 billion in 1968, that Congress became concerned and passed legislation imposing a $1 million limitation (Revenue and Expenditure Control Act of 1968.)

The IRB system works as follows: A state or local government agency will issue tax-exempt bonds which carry lower interest cost than taxable bonds. It may go a further step (including within this issue the funds for several projects, which of course, saves underwriting and administrative expenses). The proceeds are then used to buy or build facilities and equipment which private companies have pre-arranged to buy (usually on installment) or lease for a period of 5–30 years.

All but 3 states actively use such financing, which substantially reduces costs of capital for participating small businesses.

The additional use of these bonds was confined to industrial facilities but in recent years use spread to trade, commercial and service enterprises.

An example of the broad advantages of IRB financing can be illustrated with an example with which we are familiar. A small Georgia company was able to initiate a new line of agricultural cultivators and combines using a $2 million county-sponsored IRB carrying an interest rate of 8½ percent. The company created approximately 100 new jobs at a cost to the government estimated to be less than $1,000 per job.

When the question of restricting industrial revenue bonds first arose last September, the National Small Business Association voiced its support of a number of improvements, including a requirement of local hearings, reporting of all IRB projects to the Treasury Department, and a comprehensive evaluation with recommendations for curbing any uses found to be inappropriate.

The Congressional Budget Office study of April 1981, found that 93 percent of the number and 84 percent of the volume of such bonds finance businesses other than the "Fortune 1000." A New York State survey found that three-quarters of the issues benefited firms with yearly sales of less than $20 million, and one-half went to very small enterprises with sales of $1 to $5 million annually.

On August 24, 1981, the IRS issued Rev. Rul. 81-216 establishing an IRS test to determine whether multiple lots of bonds will qualify for separate exemptions. This new regulation in effect prevents government entities from bundling small issues into a larger bond offering. The new rule requires that each small offering be handled individually, each incurring its own administrative and underwriting costs.

On December 11, 1981, Frank S. Swain, Chief Counsel for Advocacy, submitted comment on the IRS regulation. The comment stated that the new rule would "substantially impair an important mechanism which enables small business to raise badly needed capital. . ."

In response to such objections, the Administration's February proposals would lift an administrative restriction IRS imposed on "small issue" IRBs. But, the bad news is that assets acquired or constructed with the proceeds of an IRB would, under the Administration's proposal, *not* be eligible for the faster ACRS recovery periods.

Furthermore, for interest on IRBs issued after December 31, 1982 to be tax-exempt, the issues would be required to meet 6 conditions above and beyond current conditions. They are:

The highest elected official or legislative body of the government unit issuing the IRB (and in which the facility is located) must approve the action after public hearings. Public approval could be met by a voter referendum.

For bonds issued after December 31, 1985, the issuing government unit must make a contribution or commitment to the financed facility through cash, a tax credit, abatement, additional services or payment of bond issuance expenses. The

present value of the commitment must be equal to at least one percent of the face of the issue. The commitment could be satisfied by insuring or guaranteeing the IRBs or by designating them as general obligations of the issuer.

IRB-financed depreciable assets must be depreciated using the straight-line method over the recovery period prescribed for earnings and profits computations.

"Small issue" IRBs would be limited to those companies with less than $20 million of capital expenditures over a 6-year period (extending from the preceding 3 years to the 3 years following IRB issuance) regardless of where incurred. A limit of $10 million outstanding IRBs per taxpayer would be allowed.

IRBs must be in registered form and reports must be filed with the IRS by the issuer.

Arbitrage restrictions are extended to reserve bonds and funds during temporary construction periods to preclude unlimited yields. Bond issuance costs are not included in determining whether the arbitrage limits are exceeded.

We have favored reasonable hearing, approval and reporting requirements incident to the issuance of IRBs and hope any limitations can be limited to these spheres.

We would therefore support reasonable limitations on this form of financing that would leave the medium open for legitimate qualified small business firms.

Modified Co-Insurance. We do not believe this issue concerns the small business community.

Construction Period Interest and Taxes. On the surface it would appear that the proposal would equate the tax treatment of interest for corporations with that presently applying to individual taxpayers. However, the proposal comes in the context of a building industry which has been depressed for the last three years.[1] As a consequence, some economists are predicting a restructuring of the entire construction business toward a "smaller scale industry." ("Home builders expect a persistent slump, with a slow recovery, shrinking industry" Wall Street Journal, February 8, 1982, page 29:4)

With this background, we believe that Congress should hesitate to impose additional taxes at this time, particularly to the extent smaller firms are involved.

Alternative Corporate Minimum Tax. Since the majority of smaller incorporated business already pay taxes with effective rates well above 15 percent, NSB does not feel that this provision will have any direct significant impact on small business. To the extent that a 15 percent minimum might result in substantial additional Treasury revenues which would help reduce deficits and relieve some of the upward pressure on interest rates, NSB believes this provision should be given careful consideration.

Withholding on interest and dividends. We agree with Secretary Regan that a de minimis provision should apply in this area either in terms of the number of recipients or the amount involved or both. This could avoid burdensome paperwork which is not cost-effective in collecting revenues. Perhaps the 25-person standard of the small business (Subchapter S) corporation would be an appropriate standard.

Acceleration of corporate tax payments. Again, we would like the Congress to evaluate the details of this proposal in the context of the high interest rates and cash flow difficulties which, since October 1979, have made it so difficult for small businesses to finance inventories and receivables.

Patent fees. There is likewise a differential between small and large businesses in the impact of sharply increased fees for issuance and maintenance of patents. Costs for patent applicants are already increasing materially under Public Law 96-517, which small business supported. However, this 1983 proposal would require patent applicants to pay for 100 percent of patent office costs on the theory that they alone are the "users" of the office. This is an incomplete view, since society as a whole derives the major benefits from innovation. Large corporations are far more able to bear such costs. Therefore, a higher fee schedule across the board will place small businesses and individual inventors at an even greater disadvantage than under the present law.

Throughout this century, half of all innovations came from these sources, so it would be very much in the interest of the economy as well as small enterprise to modify this proposal.

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[1] During 1981 building industry bankruptcies rose 56 percent from 1980, with housing production hitting a post-war low of 1,086,000 units.

LEVEL OF THE REVENUE REDUCTIONS

The Administration's budget projections for the 1981-87 fiscal years are as follows:

U.S. BUDGET DEFICITS

[In billions of dollars, fiscal years]

	1981	1982	1983	1984	1985
Administration as announced February 1982 (includes assumption that recommendations will be adopted)	−57.9	−98.6	−91.5	82.9	71.9
Current services basis:					
Administration	−57.9	−99	−127	−130	−110
CBO 2/25	−57.9	−109	−157	[1] −188	[1] 208
DRI 1/25 (with "likely" changes)	−57.9	120.3	−152.0	−188.9	
Chase 2/25	−57.9	−125	−148	−193	215

[1] Approximate.

However, commentators across a spectrum of viewpoints have noted that these totals are conservative. Among other things, they are contingent upon Congressional approval of almost $56 billion of fiscal year 1983 specific revenue and spending actions.

Without changes of this magnitude, forecasters such as Data Resources, Inc. predict fiscal year 1982-1984 deficits of $120.3 billion, $152.0 billion and $188.9 billion. ("Economic Policy and the Economic Outlook," testimony by Allen Sinai, Senior Vice President, Data Resources, Inc., before the Joint Economic Committee, January 20, 1982, pages 4 and 21.)

In our view, it is just such expectations that have been keeping interest rates in the 20 percent range for small business for almost two and one-half years.

According to the testimony of a highly respected former chairman of the Council of Economic Advisers, Alan Greenspan:

"It is not the supply in the short run of government securities that is keeping interest rates high. It is the expectation that deficits are $120, $150 or $200 billion in the latter part of the 1980s that is causing the problem today." (Testimony before the Senate Small Business Committee on "Interest Rates and Business Credit Needs," September 23, 1981, page 139.)

As the Committee is aware, those conditions resulted in over 17,000 business failures last year (according to Dun & Bradstreet). This represented a 45.1 percent increase over calendar year 1980, and a 96 percent increase over the average of the previous five years. It is within a whisker of the 1961 total, which was the highest since the Depression.

Accordingly, we believe that the state of small business at this time is precarious.

We heartily endorse Administration goals of creating more savings and investment. We also believe that the prospective deficits for 1983 and beyond are too high, and that the Legislative and Executive branches should cooperate in putting the budget on a path which is closer to fiscal balance, thus enabling the Federal Reserve to make compensatory adjustments in monetary policy.

As Data Resources, Inc. pointed out:

". . . the paradox is that a rising deficit itself can bring about an even worse deficit through raising interest rates, slowing real growth, increasing unemployment and restraining inflation. Measures to reduce the deficit, such as raising taxes, or lowering spending, could reverse this set of results." (January 20, 1982, testimony, page 22)

We believe, in these ways, the same objectives can be reached in a manner which is more balanced for the economy and less threatening to small business. Our 15 million small firms account for about 80 percent of existing jobs, 70-80 percent of new employment, and over half of the industrial innovations that are the country's best hope for increased productivity and international competitiveness. They represent a wellspring of opportunity for all our citizens.

It has become widely recognized that a one percent reduction in the unemployment rate cuts the budget deficit by $20 to $30 billion. It is because of this that we have consistently advocated the general jobs tax credit as a cost-effective way to make greater use of small businesses in the solution of many of the central problems of the economy.

A policy which encourages small business will result in the kind of economic tax growth, productivity, job creation, exports and our overall performance that the Administration and the Congress seek.

If tax policy swings further against small firms at this critical juncture, we are gravely concerned about the perils for both the small business community and the national economy.

EXHIBIT

Revenue: The Source of Half the Deficit Cuts

The Reagan Administration hopes to increase the government's revenues by $27.6 billion next year and by $170 billion during the next five years. That represents almost half of the deficit-cutting measures it is proposing for fiscal 1983 and more than a third of those sought for 1983 through 1987.

You won't find those numbers in the budget sent to Congress on Feb. 8, however, unless you read it very carefully. They represent the total of all measures that would increase the dollars collected by the Treasury, whether directly through taxes or user fees, indirectly by improving tax collection procedures or through the back door by selling government assets.

The budget lists $55.8 billion in deficit reductions for 1983 and $477 billion through 1987. The 25 revenue raisers would account for 49 per cent of the total in 1983 and 36 per cent for all five years.

The Administration doesn't characterize these measures as tax increases. Instead, the budget groups its 25 revenue proposals under a variety of headings, only one of which—"selected tax revisions"—is meant to suggest actual tax policy changes. The others are listed under "improved tax collection and enforcement," other "management initiatives," and "user fees." Following is a list of proposed steps.

Selected tax revisions. These would raise $7.2 billion in fiscal 1983 and $65.8 billion in 1983-87, as follows:

- Completed contract accounting—This accounting method, by which companies defer taxes on income from long-term contracts, would be disallowed. 1983 revenue gain: $3.3 billion. 1983-87: $17 billion.
- Business energy tax credits—These credits for investment by business in energy-saving equipment and structures would be repealed as of next Jan. 1. 1983 gain: $100 million. 1983-87 gain: $2.3 billion.
- Tax-exempt bonds—Their use for industrial development and other purposes would be curtailed. 1983 loss: $200 million. 1983-87 gain: $6.6 billion.
- Modified co-insurance—Insurance companies are now able to make co-insurance deals that reduce their tax liability. The Administration proposes to eliminate these "unintended tax benefits." 1983 gain: $1.1 billion. 1983-87 gain: $11.5 billion.
- Capitalization of interest and taxes incurred during construction period—Firms would no longer be able to write off these costs immediately. 1983: $500 million. 1983-87: $4.6 billion.
- Corporate minimum income tax—This tax would be revised and would apply only to those corporations that pay very low regular tax rates. 1983: $2.3 billion. 1983-87: $23.8 billion.

Improved tax collection and enforcement. This category, a subsection of "management initiatives," would bring in $5.5 billion in 1983 and $21 billion in 1983-87.

- Withholding on interest and dividends—Five per cent of taxable interest and dividends would be withheld. 1983: $2 billion. 1983-87: $8.2 billion.
- Corporate tax collection speedup—Firms would be required to pay 90 per cent of estimated liability instead of 80 per cent and to remit the remaining liability sooner. 1983: $1.4 billion. 1983-87: $4 billion.
- IRS enforcement—The Internal Revenue Service would increase its enforcement staff by more than 5,000. 1983: $2.1 billion. 1983-87: $8.8 billion.

Other management initiatives. Although these steps increase flows of money into government coffers, they are counted as "negative outlays" and thus reduce federal spending. The five steps listed here would raise $12.4 billion in 1983 and $64.5 billion in 1983-87.

- Improved debt collection—Delinquent debtors would be pursued with more vigor and new delinquencies would be avoided. 1983: $1 billion. 1983-87: $8 billion.
- Federal property disposition—"Underused" federal property would be sold and other property would be managed more efficiently. 1983: $1 billion. 1983-87: $17 billion.
- OCS leasing—Leases of Outer Continental Shelf tracts with greater potential for oil and gas production would be accelerated. 1983: $8.4 billion. 1983-87: $33.7 billion.
- Assets sales management—Sales of government assets would be managed more effectively. 1983: $1.3 billion. 1983-87: $4 billion.
- Mortgage insurance—The method for charging home buyers for federal insurance premiums would be changed. 1983: $684 million. 1983-87: $1.8 billion.

User fees. The budget makes no fewer than 12 proposals to institute new user fees or increase old ones. A revenue gain of $2.5 billion is predicted for 1983, and gains would total $18.3 billion in 1983-87. The individual proposals come from the budget document entitled "Major Themes and Additional Budget Details." The revenue generated by the components falls somewhat short of the total new revenue claimed elsewhere in the budget.

- Aviation—The tax levied on airline passengers would be increased to 8 per cent and taxes on general aviation gasoline and jet fuel would be raised. 1983: $1.2 billion. 1983-87: $7.7 billion.
- Coast Guard services—Commercial and recreational boat users would be required to pay the Coast Guard for its services. 1983: $200 million. 1983-87: $3.4 billion.
- Commodity trading fees—Traders would pay enough to cover all costs of the Commodity Futures Trading Commission. 1983: $22 million. 1983-87: $111 million.
- Energy regulation—New and increased fees would be charged to those using services of the Federal Energy Regulatory Commission. 1983: $35 million. 1983-87: $172 million.
- Inland waterways—Traffic would be charged for costs of federally financed improvements to the inland waterways. 1983: $448 million. 1983-87: $2.4 billion.
- Nautical and aeronautical maps and charts—Increased fees would allow the government to recover all its costs by 1985. 1983: $14 million. 1983-87: $175 million.
- Patents and trademarks—Fees would be increased to cover full costs of processing applications. 1983: $39 million. 1983-87: $234 million.
- Nuclear waste disposal—Fees would be charged nuclear utilities to cover costs of waste disposal. 1983: $300 million. 1983-87: $2.6 billion.
- Recreation—Entrance fees at federal recreation areas would be increased. 1983: $63 million. 1983-87: $344 million.
- Veterans' housing loan guarantees—Recipients of loan guarantees would have to pay a fee equal to 0.5 per cent of the loan. 1983: $95 million. 1983-87: $535 million.
- Ginnie Mae mortgages—Fees charged issuers of Government National Mortgage Association securities would be increased. 1983: $4 million. 1983-87: $20 million.
- Grievance arbitration—Fees would be instituted to cover the costs of government provided services. 1983: $5 million. 1983-87: $25 million.—**Timothy B. Clark**

NATIONAL SMALL BUSINESS ASSOCIATION,
Washington, D.C., April 12, 1982.

Ms. EMILY BRISENDINE,
Staff Assistant, House Committee on Ways and Means, 1102 Longworth House Office Building, Washington, D.C.

DEAR Ms. BRISENDINE: Please add the following associations to the list of names supporting William Barth's testimony (on behalf of the National Small Business Association) of March 30, 1982 on the Administration's revenue provisions:

American Textile Machinery Association.
Architectural Precast Association.
Building Service Contractors Association International.
Business Advertising Council.
Direct Selling Association.
Eastern Manufacturers and Importers Exhibit.
International Association of Trade Exchanges.
Menswear Retailers of America.
National Association of Brick Distributors.
National Association of Plastic Fabricators.
National Electrical Contractors Association.
National Home Furnishings Association.
National Tooling and Machining Association.
Retail Bakers of America.
United Federation of Small Business.
Web Sling Association.

Thank you,
Sincerely,

HERBERT LIEBENSON, *President.*

Mr. GIBBONS. Thank you, Mr. Barth.
Our next witness is Mr. Jerome J. McGrath.

STATEMENT OF JEROME J. McGRATH, PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA, ACCOMPANIED BY JOHN W. F. FAIRCLOTH, VICE PRESIDENT, TAXES, COLUMBIA GAS SYSTEM SERVICE CORP.

Mr. MCGRATH. Thank you, Mr. Chairman.

I am Jerome McGrath, president of the Interstate Natural Gas Association of America. With me today is John W. F. Faircloth, vice president, taxes, Columbia Gas System Service Corp.

Our association consists of virtually all of the major interstate natural gas transmission companies operating in the United States today. I would like briefly this morning—this afternoon, rather, to discuss three provisions of the administration's tax revisions and improved collection and enforcement proposals.

These are the new alternative corporation minimum tax, repeal of the energy tax credit, and the proposal to require corporations to pay 90 percent of their estimated tax liability.

Before discussing these items, however, I want to make two basic points to the committee. First, INGAA recognizes the real political and economic problems faced by Congress in attempting to reduce the anticipated budget deficits. Second, the natural gas pipeline industry has been and will continue to be a substantial taxpayer for many years.

Now, with respect to the alternative minimum corporation tax, we are opposed to that tax because we believe that such legislation will deter or discourage efforts by the industry to make this Nation more energy self-sufficient. Just a very few years ago energy shortages were all too common occurrences throughout this country. Because of the negative economic and political implications of these

shortages, many of the pipeline corporations, with congressional support and encourgement, entered into long-term, very capital intensive projects, including the construction of LNG facilities, coal gasification projects, and new pipeline systems which will deliver gas from the Outer Continental Shelf, Alaska, and other new areas.

As a direct result of this huge capital commitment, which has already done a great deal to provide additional supplies of natural gas, the industry is generating and will continue to generate substantial amounts of investment credit, as well as to incur some of the so-called tax preference items, most prominently intangible drilling costs.

For the Congress to change the ground rules under which our industry has in good faith committed its capital will have significant negative impact on our industry's ability to commit to new energy projects, and perhaps in some cases to continue with those that they have already begun.

Now, as I mentioned, we recognize the difficult problem that the Congress is faced with. We would be pleased to work with the committee to find less complex, administratively burdensome, and less harmful methods to reduce budgetary pressures.

For example, a simple and far more evenhanded approach to the proposal before you would be to reduce the investment tax credit income limitation to perhaps 75 percent from the 90 percent that became effective this year. This would increase revenue, but would do so in a less complex manner than the new proposed tax. If the Congress, however, should pursue the enactment of a minimum tax in some form, then INGAA proposes the following be considered.

One, corporations should be permitted to utilize up to 50 percent of their available tax credits for the year in arriving at their minimum tax liability. The balance of the available credits would be carried forward for use in subsequent years.

Two, the proposal regarding intangible drilling costs should be clarified so that the proposed 10-year amortization effect should not be applied on a well by well basis. Instead, the offset should be utilized against IDC on other wells drilled by the taxpayer, because there will be little, if any, IDC after production has started or where the well is abandoned in a subsequent year before the costs have been recovered.

We believe that all IDC on producing wells should be amortized in full over the 120-month period when computing the minimum tax.

Three, that corporations be allowed a new annual election as to whether they wish to deduct intangible drilling costs currently or amortize these costs over a 60-month period. If the purpose of the minimum tax is to tax economic profits, it is hard to understand why tax is being imposed upon drilling expenditures before it is known whether these costs will be recovered with a profit.

The second proposal I would like to briefly mention is the repeal of the energy tax credit. Without the credits, long-term energy projects will not get off the ground. Many are of such a magnitude that even if some future Congress sees fit to reinstitute the credits, energy from these sources will be delayed for many, many years.

If Congress does repeal the credit, it should be clarified that taxpayers who have and can establish that they have committed more

than de minimis amounts to proposed energy projects or have projects under construction will be entitled to the full amount of credit with respect to the project's cost.

Finally, Mr. Chairman, INGAA believes that the proposal to accelerate estimated corporate tax payments to 90 percent should be amended, because it would be virtually impossible for most corporations to estimate their tax liabilty within 90 percent of actual. We recommend that the penalty provision for an underpayment be eliminated for corporations, and that a deductible interest charge be substituted.

INGAA stands ready to work with the committee to help reduce the projected budget deficits and get this Nation back on the road to economic prosperity. We believe we have made some positive suggestions to modify the proposals you have before you, and we urge their adoption by the committee.

We appreciate the time afforded us to present our concerns, and we would be pleased to answer any questions the committee may have.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF JEROME J. MCGRATH, PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

I am Jerome J. McGrath, President of the Interstate Natural Gas Association of America (INGAA). I am accompanied by John W. F. Faircloth, Vice President, Taxes, Columbia Gas System Service Corporation. INGAA is a non-profit national trade association whose membership consists of virtually all of the major interstate natural gas transmission companies in the United States. INGAA's members account for approximately 90 percent of the natural gas that is transported and sold in interstate commerce.

Natural gas constitutes approximately one-fourth of the total energy consumed by our economy. The features of safety, cleanliness, and reliability make gas a desired fuel. In addition, when burned, gas releases virtually no pollutants and, thus, poses no environmental threat. Ninety-six percent of the gas consumed in this country is produced domestically and, therefore, is invulnerable to foreign embargo. Gas supplies about 40 percent of the total energy requirement of the U. S. industrial sector. As you can see, gas has occupied an essential role in our society. We feel confident that gas can continue to maintain its important place in our energy picture. To do this, however, it is essential that the tax treatment accorded our industry be such as to encourage rather than to discourage the substantial investments needed to meet this challenge.

I am appearing before the Ways and Means Committee to discuss three provisions of the Administration's Tax Revisions and Improved Collection and Enforcement Proposals. They are: the new alternative corporation minimum tax; repeal of the energy tax credit; and the proposal to require corporations to pay 90 percent of their estimated tax liability.

Before commenting on the proposed corporation minimum tax, I would like first to make two basic points. One, INGAA recognizes the real political and economic problems faced by Congress in attempting to reduce the anticipated budget deficits. Two, the natural gas pipeline industry has been and will continue to be a substantial taxpayer for many years.

INGAA is, however, opposed to enactment of the alternative minimum corporation tax because we believe that such legislation will deter or discourage efforts by our industry to make this nation more energy self-sufficient. To the extent the alternative tax is a response to the revenue implications and industry patterned tax benefits produced by the Economic Recovery Tax Act (ERTA), we believe it would be better to specifically scrutinize ERTA's impacts and to squarely address any structural defects that may be identified.

Just a very few years ago, energy shortages were an all too common occurrence throughout our nation. Because of the negative economic and political implications of these shortages, many of the pipeline corporations with Congressional support

and encouragement, entered into long-term, very capital intensive projects including the construction of LNG facilities, coal gasification projects and new pipeline systems which will deliver gas from the Outer Continental Shelf and Alaska. Many of these same corporations have also developed large exploration and development programs to augment gas reserves.

As a direct result of this huge capital commitment, which has already done a great deal to provide additional supplies of natural gas, the industry is generating and will continue to generate, substantial amounts of investment credit as well as to incur some of the so-called "tax preference" items, most prominently, intangible drilling costs. This industry was directly encouraged by the Federal government over several Administrations and during several Congresses, to pursue these ventures and was indirectly urged to allocate its capital in certain ways through the tax code by means of these credits and preferences.

In most instances, costs were determined by assuming a certain tax policy that existed prior to 1982. For the Congress to change the "ground rules" under which our industry has in good faith committed its capital, will have a significant negative impact on our industry's ability to commit to new energy projects and perhaps, in some cases, to continue with those that have already begun. For some of our members, the alternative tax will amount to a tax on the investment tax credit, thus reducing its economic value. Such a tax on the investment credit may not be, probably will not be, borne by other of our member companies. Thus, some will receive the full benefit of the investment tax credit and some will not. This raises a very serious issue as to what the investment credit is intended to do and how it is to be utilized by the business community.

Allow me to cite one example of the future effect the proposed minimum tax will have on one of INGAA's members. I am told that this example, while not universal, is nevertheless not atypical with our membership.

In 1981, this corporation paid Federal income taxes of $161,000,000 which is a sizable sum for corporations the size of many of INGAA's members. In 1983, the first year of the proposed minimum tax, the company has estimated that its regular income tax before investment credit will be $86,000,000. Because of this company's participation in a coal gasification project, as well as other construction activities, it had expected to utilize an investment tax credit of $65,000,000 leaving a tax payment of $21,000,000. A rough computation of this corporation's liability under the proposed minimum tax would produce a tax of $51,000,000.

Perhaps even more significant is the fact that unlike the example given by the Treasury wherein the alternative tax credit carry forward is used as quickly as in year two, a carry forward of the difference between the regular and the minimum tax for the company in our example, i.e., $30,000,000, could not be utilized in any year through 1986, and the credit would continue to increase year by year to a 1986 total of $132,000,000. (The corporation has no estimate of tax beyond 1986.) Under the interest rates prevailing today, the present worth of a dollar that cannot be utilized for several years would indeed be small and hardly the kind of incentive to meet the nation's growing energy needs. More generally, such a pattern amounts to a permanent diminution in the value of the investment tax credit as a direct result of the alternative minimum tax.

Earlier in my statement, I mentioned the fact that growing budget deficits must be dealt with, and members of Congress have a most difficult problem on their hands in the budget area.

Mr. Chairman, INGAA recognizes this problem and will be pleased to work with the Committee to find less complex, administratively burdensome and potentially harmful methods to reduce budgetary pressures. For example, a simple and far more even-handed alternative approach to the proposal before you would be to reduce the investment tax credit income limitation to perhaps 75 percent from the 90 percent that became effective this year. This would increase revenue but would do so in a less complex manner than the new proposed tax.

If, however, Congress decides to pursue the enactment of a minimum tax in some form, then INGAA proposes the following be considered:

(1) Corporations should be permitted to utilize up to 50 percent of their available tax credits for the year in arriving at their minimum tax liability. The balance of the available credits would be carried forward for use in subsequent years.

(2) The proposal regarding intangible drilling costs should be clarified so that the proposed ten year amortization offset should not be applied on a well-by-well basis. Instead, the offset should be utilized against IDC on other wells drilled by the taxpayer because there will be little if any IDC after production has started or where the well is abandoned in a subsequent year before your costs have been recovered.

We believe that all IDC on producing wells should be amortized in full over the 120-month period when computing the minimum tax.

(3) That corporations be allowed a new annual election as to whether they wish to deduct intangible drilling cost currently or amortize these costs over a 60-month period.

If the purpose of the minimum tax is to tax economic profits, it is hard to understand why a tax is being imposed upon drilling expenditures before it is known whether these costs will be recovered with a profit.

Mr. Chairman, the second proposal I would like to discuss briefly is the repeal of the energy tax credit. As I mentioned previously, a number of our member companies have in complete good faith and with serious intent started long-term energy projects in reliance upon receiving the energy credit. Others have committed many millions of dollars in engineering studies and costs preparatory to commencement of projects but have not yet reached the contracting stage. It is extremely doubtful that these projects can be financed and contructed absent the energy credit. Without the credits, long-term energy projects will not get off the ground and are of such a magnitude that, even if some future Congress sees fit to reinstate the credits, energy from these sources will be delayed for many, many years. In considering its position on the energy credits, the Committee should recognize it is being asked to revisit fundamental issues of energy policy and objectives; issues just recently settled by Congress after prolonged debate. If Congress does repeal the credit, it should be clarified that taxpayers who have, and can establish they have, committed more than merely *de minimis* amounts to proposed projects, or have projects under construction, will be entitled to the full amount of credit with respect to the project's cost.

Finally, INGAA believes that the proposal to accelerate estimated corporate tax payments to 90 percent should be amended. Because it will be virtually impossible for most corporations to estimate their tax liability within 90 percent of actual, over the course of its current tax year, the imposition of a penalty for the failure to properly estimate taxable income is unreasonable. For example, our industry experiences unpredictable changes in taxable income because of the weather, changing consumer demands and the cyclical nature of some of our diversified activities. Therefore, we recommend that the penalty provision for an underpayment be eliminated for corporations and that a deductible interest charge be substituted.

Mr. Chairman, INGAA stands ready to work with the Committee to help reduce the projected budget deficits and get this nation back on the road to economic prosperity. We believe we have made some positive suggestions to modify the proposals you have before you, and we urge their adoption by the Committee. We appreciate the time afforded us to present our concerns, and I would be pleased to answer any questions which you or other members may have.

Mr. GIBBONS. Thank you, sir.

Our last witness at this time is Mr. Wallace J. Clarfield.

STATEMENT OF WALLACE J. CLARFIELD, CHAIRMAN, POLICY COMMITTEE, THE TAX COUNCIL (VICE PRESIDENT, TAXES, OLIN CORP.)

Mr. CLARFIELD. Thank you, Mr. Chairman.

I am Wallace J. Clarfield, vice president, taxes, of Olin Corp. of Stamford, Conn. I appreciate this opportunity to present a brief statement on behalf of the Tax Council, on which I serve as chairman of the policy committee and a member of its board of directors.

The council strongly supported most provisions of the Economic Recovery Tax Act of 1981. We remain convinced that the principal decisions under that legislation will bear substantial fruit in revitalizing the private sector in years to come.

Obviously we are in a sharp recession now, with no sign of real recovery in sight as yet. Mainly because of the recessionary shortfall in revenues, this has produced a much higher budget deficit for fiscal 1982 and 1983 than anticipated earlier. Substantial deficits

are anticipated for future years, and under certain assumptions these deficits would widen considerably.

Now, however, the recession is accounting for three-quarters of the fiscal 1982 deficit, and according to the administration projection, two-thirds of the fiscal 1983 deficit.

In this context, we do not think it makes sense to raise burdensome taxes on either corporations or on individuals. In fact, with bankruptcies on the rise, the threat of new taxes may become just as disruptive of business confidence and the health of financial markets as the fear of future budget deficits.

One of the principal objectives of last year's tax bill was to instill a greater sense of tax policy certainty for both business and individual taxpayers. Financial and investment planning could count on a given direction in tax policy over a prolonged period. Of course, investment planning is being adversely affected by high interest rates in the current recession, but it is also threatened by new tax burdens that would negate a large part of the tax relief under ERTA. This will do nothing to encourage new investment and employment.

As to the minimum tax, the council has consistently opposed the concept of a minimum tax on corporations regardless of its reach. We have viewed the minimum tax as an an artificial and unwarranted penalty on the employment of tax relief provisions that by themselves are considered appropriate and constructive. There is no economic rationale for the minimum tax, particularly as applied to the corporate sector.

The administration's revenue estimates for the new minimum tax rise from $2.3 billion in 1983 to almost $5 billion in 1984, and accumulate to $19 billion over the next 5 years. This implies a significant new burden on corporate enterprise. Even assuming that Congress does nothing to expand the tax base, and it does not become a new checkbook for spending programs, most of the planned tax increase would involve restrictions on the employment of the investment tax credit and net operating loss deductions in direct opposition to the investment incentives of ERTA.

Now, as proposed by the administration, the new minimum tax would be a true alternative tax to be paid in lieu of alternative tax that would be higher. This would be an improvement over the base add-on minimum tax. There is no way to design a new overall minimum tax in either an overall or an add-on that would not adversely affect tax provisions that Congress has agreed on as maintaining national objectives.

As to other revenue enhancers, the council recognizes that a number of other proposals to raise new revenue in fiscal 1983 would have an adverse effect on the business sector. We take no position on the proposals applying to particular industries, but we do oppose the further acceleration of corporate tax payments. This is a one-shot tax increase which would create substantial additional administrative burdens forever. It is simply not worth the temporary revenue gain.

The council does support the administration's request to increase the Internal Revenue Service audit capacity. We view this as a necessary move to improve tax compliance and it could result in substantial net revenue gain.

As to future years, neither Congress nor the administration has come to grips really with a core problem behind the preimposed recession deficits. That is, simply the continued expansion of the major indexed entitlement programs. To date, cutbacks on the spending side have disproportionately fallen on other areas of the budget, and have barely scratched the major entitlement programs. Very significant additional budget savings to narrow future deficits can be found by spreading the expenditure control effort to slow the growth of these programs.

If, after all possible expenditure control efforts have been made and deficits in future years beyond 1983 are still expanding rapidly, consideration should be given to increasing taxes as a last resort measure. Any such increases should leave the post-ERTA structure of the income tax system in place.

Thank you.

[The prepared statement follows:]

STATEMENT OF WALLACE J. CLARFIELD ON BEHALF OF THE TAX COUNCIL

I am Wallace J. Clarfield, Vice President-Taxes of Olin Corporation of Stamford, Connecticut. I appreciate this opportunity to present a brief statement on behalf of The Tax Council, which I serve as Chairman of the Policy Committee and as a member of the Board of Directors. The Tax Council is a non-profit business membership organization concerned with federal tax policy. Our members represent a wide range of business enterprise including heavy and light manufacturing, energy, mining, transportation, public utilities, consumer products and services, retailing, public accounting, banking, and other financial services.

The Council's statement can be summarized as follows:

(1) The Council does not believe that the midst of a sharp recession is a time to raise taxes on either individuals or corporations.

(2) The proposed minimum tax on the corporate sector, in particular, would be a counter-productive measure and should not be adopted.

(3) The Council supports the Administration's request for increased IRS audit capacity to improve tax compliance.

(4) Congress should consider new tax burdens only if deficits in future years beyond fiscal 1983 are actually expanding and only after all possible efforts to reduce the growth of the major entitlement spending programs have been made.

ECONOMIC CONTEXT

The Council strongly supported most provisions of The Economic Recovery Tax Act of 1981. We remain convinced that the principal decisions under that legislation, particularly the individual rate reductions, the Accelerated Cost Recovery System, tax relief for R&D, and the permanent savings incentives—will bear substantial fruit in revitalizing the private sector in the years to come.

Obviously, we are in a sharp recession now with no sign of real recovery in sight as yet. Mainly because of the recessionary shortfall in revenues and increases in mandated spending, this has produced a much higher budget deficit for fiscal 1982-1983 than anticipated earlier. Substantial deficits are projected for future years, and under certain assumptions these deficits would widen considerably. Now, however, the recession is accounting for three quarters of the fiscal 1982 deficit, and according to the Administration projection, two-thirds of the fiscal 1983 deficit.

Hopefully, recovery from the recession will set in later this year. But there is no assurance that it will be strong enough to raise economic activity to any satisfactory level in fiscal 1983, which starts only six months away. Depressed levels of corporate earnings will continue to be a drag on capital spending and employment. Sales of major durable goods industries are likely to continue sluggish through much of fiscal 1983.

In this context we don't think it makes sense to raise burdensome new taxes on either corporations or individuals. In fact, with bankruptcies on the rise, the threat of new taxes may become just as disruptive of business confidence and the health of financial markets as the fear of future budget deficits. One of the principal objectives of The Economic Recovery Tax Act of 1981 was to instill a greater sense of tax policy certainty for both business and individual taxpayers. Financial and invest-

ment planning could count on a given direction in tax policy over a prolonged period. Of course, investment planning is being adversely affected by high interest rates and the current recession, but it is also threatened by new tax burdens that would negate a large part of the tax relief under ERTA. This will do nothing to encourage new investment and employment.

THE MINIMUM TAX

The Council consistently has opposed the concept of a minimum tax on corporations, regardless of its reach. We have viewed the minimum tax as an artificial and unwarranted penalty on the employment of tax relief provisions that by themselves are considered appropriate and constructive. There is no economic rationale for the minimum tax, particularly as applied to the corporate sector.

There is the possibility, of course, that through interaction of various tax provisions, some corporations will pay very low, or even zero, effective rates of tax. If it is deemed to be a critical national objective that all corporations pay a significant income tax, there is some political justification for the corporate minimum tax. We just don't believe this to be a pressing issue now or before. The existing minimum tax, in fact, was brought in as an afterthought by a Senate amendment to the 1969 Tax Reform Act. The original Treasury papers and studies which gave rise to most of the provisions of the 1969 Act recommended against a corporate minimum tax on the basis that it could not take into consideration the particular circumstances and problems of different industrial sectors calling for particular tax treatment. And that is precisely the problem with the existing minimum tax, which has had most of its impact on companies and industries with low earnings in depressed markets. Clearly, if there was no perceived need to reduce the budget deficit, the minimum tax would not have been proposed in the name of "distributional equity" for the corporate sector.

Even if one is taken with the notion of enforcing a "fairer" distribution of corporate tax liabilities, the minimum tax approach is a badly flawed tool. It is discriminatory in several ways. Its revenue yield to a large extent depends on retroactive application to past investments entered into, of course, without calculation of a minimum tax liability, especially in the case of depreciable assets, leases, and tax-exempt obligations. By including a set number of so-called "tax preferences" in the base, the minimum tax discriminates arbitrarily between those businesses employing a few such preferences on a relatively large scale and those that use a relatively large number of relief provisions not included as preferences but whose total tax reduction from relief provisions could be approximately the same. The only way to "correct" this would be to include all so-called corporate tax preferences, or tax expenditures, in the tax base—a completely unworkable arrangement.

The tax would certainly complicate business tax planning. It could encourage uneconomic mergers or discourage necessary rescues of failing firms to avoid triggering of the minimum tax. It would involve numerous administrative problems in any event.

The Administration's revenue estimates for the new minimum tax rise from $2.3 billion in 1983 to almost $5 billion in 1984 and cumulate to $19 billion over the next five years. This implies a significant new burden on corporate enterprise, even assuming that Congress does nothing to expand the tax base and that it does not become a new "checkbook" for spending programs. Most of the planned tax increase would involve restrictions on the employment of the investment credit and net operating loss deductions in direct contradiction to the investment incentive provisions of ERTA.

Now, as proposed by the Administration, the new minimum tax would be a true alternative tax to be paid in lieu of regular tax, if higher. This would be a structural improvement over the basically add-on present minimum tax. But there is no way to design any overall minimum tax, either an alternative or add-on, that will not adversely affect tax policy provisions that Congress has agreed upon and maintained as serving deserving national objectives.

OTHER REVENUE ENHANCERS

The Council recognizes that a number of other proposals to raise new revenues effective in fiscal 1983 would have an adverse impact on the business sector. We take no position on the proposals applying to particular industrial sectors, but we oppose the further acceleration of corporate tax payments. This is a one-shot tax increase which would create substantial additional administrative burdens forever. It is simply not worth the temporary revenue gain.

The Council does support the Administration's request to increase the IRS audit capacity. We view this as a necessary move to improve tax compliance, and it could result in a substantial net revenue gain.

FUTURE YEARS

Some projections of federal fiscal trends beyond fiscal 1983 show a worrisome widening of the budget deficit and an increase in its proportion to GNP well after the recession is expected to end. The Administration itself concedes that we will have substantial deficits through 1987, although it maintains that the trend will be downward assuming acceptance of its budget proposals. At this point it is simply impossible to design a budget and tax policy that would resolve all the fears of future deficits. One case could be made that future deficits are so huge as to require the elimination of all tax relief under ERTA if balancing the future budget is the only objective to be served. We do not believe we should plan our current national tax policy in such a self-destructing manner.

Neither Congress nor the Administration has come to grips really with a core problem behind the pre- and post-recession deficits. That is simply the continued expansion of the major indexed entitlement programs. To date, cutbacks on the spending side have disproportionately fallen on other areas of the budget and have barely scratched the major entitlement programs. Very significant additional budget savings to narrow future deficits can be found by spreading the expenditure control effort to slow the growth of these programs.

If after all possible expenditure control efforts have been made and deficits in future years beyond fiscal 1983 are still expanding rapidly, consideration should be given to significant tax increases as a last resort measure. Any such increases should leave the post-ERTA structure of the income tax system in place.

Mr. RANGEL [presiding]. The committee will stand adjourned for 5 minutes.

Mr. STARK [presiding]. We will recess for 5 minutes to finish this vote and then come right back. If you can just wait, it will just take us a minute to run over and run back. Thank you very much.

[Recess.]

Mr. GIBBONS [presiding]. I did not come here prepared to raise any taxes, and I hope I made that position clear. But I want to ask you about the President's tax-raising proposals that are before us. Let me just run down the list and see how you all feel about them. If you do not want to express an opinion, I am just going to ask you to hold up your hands. If you want to comment, go ahead and comment.

What happened to Mr. Barth? I guess we better wait for him because I would certainly like to have his input. We will wait for Mr. Barth.

[Mr. Barth takes his seat.]

Mr. GIBBONS. Let me see the hands of those who favor the President's proposal that would change the completed contract accounting rules, which between 1983 and 1987 would raise $17 billion. The entire panel votes "no" on that one.

Mr. HACKING. We do not have a position on that.

Mr. ALBERTINE. We do not have a position.

Mr. GIBBONS. You are not for it, though, right?

Mr. ALBERTINE. No.

Mr. GIBBONS. How about business energy tax credits which, if repealed between 1983 and 1987, would raise $2.3 billion? How many of you would favor that proposal to repeal?

Mr. MCGRATH. We strongly oppose it, Mr. Chairman.

Mr. GIBBONS. The rest of you either do not favor it or you are against it.

Mr. MCGRATH. We are against repealing it.

Mr. GIBBONS. You are against repealing it. The rest of you have a comme-ci, comme-ca attitude?

Mr. ALBERTINE. No.

Mr. CLARFIELD. We have not taken a position on several of these because they are specifically industry-related.

Mr. GIBBONS. I am just asking about the President's tax proposal to increase taxes. These are not mine, so do not feel like you are offending me. On tax exempt bonds, the President proposes we change those around between 1983 and 1987, which would raise $6.6 billion. Mr. Barth opposes that, I know.

Mr. BARTH. I spoke at length on that, Mr. Chairman.

Mr. GIBBONS. Yes; do the rest of you have that same "I don't give a hoot" attitude toward it? Is that right? [Laughter.]

Mr. MCGRATH. We just do not have a position on it.

Mr. GIBBONS. All right.

Here is one you can all jump on because it is not even representing insurance companies, that I know of. Here is the President's proposal to change the modified coinsurance rules, which between 1983 and 1987 would raise $11.5 billion. Are you for that President's proposal or against it?

Mr. CLARFIELD. Mr. Gibbons, we do not even understand that proposal. Barring somebody from the insurance company in the room, I doubt that anybody on the panel understands it. [Laughter.]

Mr. GIBBONS. So none of you are for it.

Mr. CONABLE. I wish to say that I resent that.

Mr. CLARFIELD. I apologize, Mr. Conable.

Mr. GIBBONS. Mr. Conable, I am just running through the list that the President has submitted to us to increase revenues between the years 1983 and 1987.

Mr. CONABLE. I suspect your motives. [Laughter.]

Mr. GIBBONS. I have made it very clear I am not for increasing taxes.

Now let's talk about the capitalization of interest and taxes during the construction period of 1983 to 1987. That will raise $34.6 billion. Is anybody for that?

[No response.]

Mr. GIBBONS. Here is a real popular one for you, imposing a corporate minimum tax or increasing it or changing it around so that between 1983 and 1987 it will raise $23.8 billion. Are any of you for that?

Mr. BARTH. That really does not impact small business, sir.

Mr. MCGRATH. We oppose it.

Mr. CLARFIELD. We oppose it, Mr. Chairman.

Mr. GIBBONS. It has not got a friend out there that I know of; is that right?

Improve the tax collection and enforcement. That would bring in $21 billion between 1983 and 1987.

Mr. CLARFIELD. Is that the one for a bigger IRS budget?

Mr. GIBBONS. I will break it down to the withholding of interest and dividends between 1983 and 1987 would bring in $8.2 billion. Are any of you for it?

[No response.]

Mr. GIBBONS. Let the record show nobody spoke up for the President's proposal.

Mr. CONABLE. Neither did I. [Laughter.]

Mr. GIBBONS. That is what I said.

Let corporate tax collection speed up. Now, there is a real gem. From 1983 to 1987 that will raise $4 billion. Who will put their head in the guillotine?

Mr. BARTH. No.

Mr. CONABLE. All in penalties and interest.

Mr. GIBBONS. Let the record show nobody supported that.

IRS enforcement between 1983 and 1987, for more staff, 5,000 more IRS agents, to raise $8.8 billion. Are any of you in favor of 5,000 more IRS agents?

Mr. CLARFIELD. Yes, Mr. Gibbons, we supported that proposal.

Mr. GIBBONS. Well, we are doing much better now. Well, the rest of them are all management initiatives. They do not fall within the scope of this committee's jurisdiction. So I will not put you all on the spot for those.

Mr. Conable, would you like to remark?

Mr. CONABLE. I was not present to hear the testimony in chief, and therefore I would not wish to inquire, but I do thank you, Mr. Chairman, for boosting the President's programs as you have.

Mr. GIBBONS. I am trying to help him out.

Thank you all very much.

Mr. CONABLE. Thank you for coming. I am sorry I did not hear your testimony, but we will read it in the record.

Mr. GIBBONS. Our next panel is from the American Bankers Association, the Investment Company Institute, Stockholders of America.

Chairman ROSTENKOWSKI. We want to welcome all of you to the committee. It is always nice to see some friendly faces back at the witness table.

Mr. Bruning, if you would identify yourself for the record and proceed with your testimony, the committee is ready to receive it.

STATEMENT OF CHARLES A. BRUNING, PRESIDENT, EDGEWOOD BANK, COUNTRYSIDE, ILL., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY PAUL R. CLAYTOR, MEMBER, AMERICAN BANKERS ASSOCIATION TAXATION COMMITTEE, VICE PRESIDENT AND DIRECTOR OF TAXES FOR THE AMERICAN FLETCHER NATIONAL BANK, INDIANAPOLIS, IND.

Mr. BRUNING. Thank you, Mr. Chairman and members of the committee.

I am Charles A. Bruning, president of the Edgewood Bank in Countryside, Ill. I am also the chairman of the Community Banking Leaders Council of the American Bankers Association.

Accompanying me today is Paul R. Claytor, who is a member of the ABA's taxation committee, and is a vice president and director of taxes for the American Fletcher National Bank in Indianapolis, Ind.

We would like to thank the committee for this opportunity to testify on behalf of the American Bankers Association on the tax proposals contained in President Reagan's budget message.

The need to bring Federal revenues and expenditures closer together is clear. It is important, however, that any tax increases do

not delay or make less likely the economic recovery beginning later this year.

The ABA believes that the President's proposal for an alternative minimum tax on corporations should be analyzed in terms of its impact on individual investment decisions and on the financing needs of State and local governments.

Under the proposed alternative minimum tax, banking's share of the tax burden would be increased by 52.6 percent. That is the largest percentage increase for any industry. In 1977, the most recent year for which Treasury statistics are available, the proportion of corporate tax paid by banking equaled the proportion of net income that banks received.

In addition to the direct Federal taxes paid by banks, the ABA believes that the indirect tax imposed on banks by Federal Reserve requirements should also be recognized. In 1980, the Federal Reserve System earned and paid to the Treasury $2.4 billion on reserves that banks were required to set aside interest-free.

Now that is an amount that is roughly equal to the amount banks accrued for Federal income taxes in that year. It would be wrong for the committee to believe, therefore, that banks pay little or no taxes, Federal income tax, or State taxes despite reporting large profits to their shareholders, as the Treasury's general explanation asserts.

If your committee decides to impose an alternative minimum tax on corporations, the item described as "deductions for debt used to carry tax-exempt securities" should be eliminated as a tax-preference item. Commercial banks hold 45 percent of all outstanding municipal bonds. Banks have traditionally been the primary source for this market. The inclusion of this item would increase the tax liabilities of banks, but the real burden would fall on State and local governments. Issuers would be compelled to increase yields in order to attract the volume of sales necessary to meet the State and local financing requirements. This increase in financing costs for State and local governments comes just as they are facing rising costs in other areas as they assume responsibility for programs that were formerly carried out by the Federal Government.

The ABA also opposes the administration's proposal to institute a system of withholding at source on dividends and interest because it would impose substantial cost burdens on consumers. At the same time, it would fail to achieve Treasury's stated purpose of increasing tax revenue and promoting taxpayer compliance.

The ABA has an interest in helping to solve the unreported income problem which has led to an ongoing consulting relationship with the Internal Revenue Service on ways to improve efficiency of income reporting and analysis. We look forward to continuing our efforts with them. Thank you. Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION, PRESENTED BY CHARLES A. BRUNING, PRESIDENT, EDGEWOOD BANK, COUNTRYSIDE, ILL.

SUMMARY OF POSITION

The American Bankers Association continues to support efforts to cut federal spending, reduce individual and business taxes, stimulate savings, investment, and

productivity, reduce federal paperwork and regulation, and control inflation through monetary policy.

At the same time, it is clear that a strong, bipartisan effort must be made to hold to the smallest figure possible the projected increase in the Federal deficit for fiscal year 1983 and the following two years. In order to do this, it will be necessary to increase Federal revenues as well as reduce, or hold steady, Federal expenditures.

In evaluating the various alternatives being considered to raise Federal revenues through increases in Federal taxes, the ABA believes the Committee should take particular care that the increases chosen do not delay, or lessen the prospect of, any economic recovery. The Administration's proposal for an alternative minimum tax on corporations, for example, should be evaluated in terms of its impact on investment decisions, its impact—or lack of impact—on various sectors of the economy, and the impact of the preference item relating to interest attributed to support of municipal bond portfolios held by banks and other institutions on the costs to state and local governments of meeting increased financing needs. While the initial incidence of this aspect of the minimum tax would be experienced by banks until they were able to reduce their holdings of these securities, the real burden clearly falls, and falls most heavily, on state and local governments.

The alternative minimum tax proposed by the Administration would go beyond what the Treasury tried to do in Rev. Proc. 80-55. The inclusion of "deductions for debt used to carry tax-exempt securities" as an item of preference would establish an irrefutable presumption that a bank incurs a portion of its interest expense for the purpose of carrying tax-exempt securities. This obscures the lack of any relationship between bank indebtedness (deposits) which must be available to customers on short notice, as contrasted with money banks lend. It also upsets the traditional function of commercial banks as substantial purchasers of state and local debt.

Increases in loan losses in substantial amounts are being reported daily by many banks due to business failures, therefore, the loan loss reserve preference item in the AMT proposal should be dropped, the deduction for loan losses maintained at 1 percent or more.

The ABA is opposed to the Administration's proposal to institute a system of withholding on interest and dividend income. The proposal is costly, complex, and ineffective. It exacerbates the overwithholding already in place. The ABA is working with the IRS to improve the efficiency of their income reporting and analysis and believes that this, rather than withholding, is the better answer.

STATEMENT

I am Charles A. Bruning, President of the Edgewood Bank in Countryside, Illinois. I am also the Chairman of the Community Banking Leadership Council of the American Bankers Association. Accompanying me is Paul R. Claytor, a member of the Taxation Committee of the American Bankers Association, who is the Vice President and Director of Taxes for the American Fletcher National Bank in Indianapolis, Indiana. I would like to thank the Committee for this opportunity to testify on behalf of the American Bankers Association on the tax proposals contained in President Reagan's budget message. The American Bankers Association is the national trade organization for more than 90 percent of the nation's 14,500 commercial banks, including more small banks than any other financial trade association.

Before commenting specifically on President Reagan's recent tax proposals, I believe it would be appropriate to comment on the circumstances under which these proposals have been made.

There were four basic objectives set forth in President Reagan's economic program:

(1) The reduction of individual and business taxes to stimulate saving, investment, work effort, and productivity.

(2) The reduction of the growth of Federal spending.

(3) The reduction of the burden of excessive Federal regulation of personal and business decisions.

(4) The reduction and control of inflation through monetary policy.

The American Bankers Association supported that program when it was proposed and we support it now. In order for the program to be successful, however, it is important that reductions in taxes be matched by reductions in Federal spending. Although great progress was made toward the goal of reducing spending in the first session of this Congress, somewhat greater progress was made toward reducing Federal taxation. As a result, the deficit projected for fiscal year 1983 is, at least, on the order of $100 billion. The recession makes the problem more complicated and its ef-

fects more severe as tax receipts are driven down and demands on unemployment assistance and other social support programs are increased.

The need to bring Federal revenues and expenditures closer together is clear. What is not clear is how this may best be done without aggravating the problem. Short term budgetary benefits of tax increases may have significant adverse effects in the long term. Furthermore, as Secretary Regan noted in his testimony before you on February 22, "There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift."

As citizens and taxpayers, we share your concern and the President's concern over the projected increase in the Federal deficit. If the deficit for 1983 is to be reduced in part by tax increases, those increases must be carefully chosen so as not to interfere with the economic recovery for which we are all working. In this connection, the ABA believes it to be important that you understand the impact certain aspects of the President's alternative minimum tax proposals will have on individual and business investment decisions and on the financing needs of state and local governments.

Before addressing details of the proposals which we find troubling, let me discuss briefly with you two matters which should be placed on the table at the outset of our discussion: First, the effective rate of Federal income tax experienced by banking generally. Second, the relationship between high interest rates and bank earnings.

EFFECTIVE RATE OF FEDERAL CORPORATE INCOME TAX

In its General Explanation of the President's tax proposal, the Treasury Department states that "The proposed corporate minimum tax would tax 'corporate profits' as measured by regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax." The Technical Explanation then goes on to say the "industries that will increase their share of corporate tax liability, on the basis of their current use of tax preferences, are petroleum, banking, and utilities". The effective rate of Federal income taxes paid by banks is probably lower than the effective rate for some other industries. It would be incorrect and unfortunate for the Committee to infer from these statements that banks pay "little or no Federal corporation income tax, despite reporting large profits to their shareholders", as it is put in the General Explanation.

All such comparisons by industry of effective tax rate should be re-examined in the light of the Economic Recovery Tax Act of 1981. No one knows what the effective rate of tax on any industry will be for 1981 because the returns are not in. What is known is that the combination of the accelerated capital recovery system and safe harbor leasing (not commercial leasing) heavily favor capital intensive—as opposed to service—industries.

The Administration's tax proposals, according to the technical explanation, would increase banking's share of the corporate income tax burden from 1.9 percent to 2.9 percent, the largest percentage increase for any industry. According to the Treasury Department's Statistics of Income for 1977, the most recently published statistics available, banking's share of corporate net income was 2.2 percent and its share of the corporate tax burden was 2.2 percent, or $1,265,984,000.

According to the 1980 Annual Report of the Federal Deposit Insurance Corporation, the Federal income tax provision for all insured banks for 1980 was $2,466,000,000. The amount actually paid in 1980 was somewhat lower because the annual tax provision includes that portion of deferred tax liabilities allocable to the current year which are payable in future years.

To be fair about industry-by-industry comparisions of effective Federal tax rates, one must increase the nominal effective rate for banking, or lower it for other industries, by a factor that reflects accurately the impact of reserve requirements placed on banks under the Federal Reserve System. Under the Monetary Control Act, financial institutions must post reserves with the Federal Reserve System on an interest free basis in direct ratio to their transaction accounts and nonpersonal time deposits. The reserves held by the Federal Reserve System are then invested primarily in government securities. Out of the $11.7 billion paid into the Treasury by the Federal Reserve system for fiscal year 1980 as receipts in excess of its operating costs, over 20 percent, approximately $2.4 billion, was generated by the investment of reserves. No other industry is subject to reserve requirements or is responsible for such Treasury receipts. This is often overlooked when discussing effective

income tax rates, yet the effect is the same as if a tax had been imposed directly on the banking industry as a whole. Revenue contributed to the United States Treasury by financial institutions indirectly through the Federal Reserve's earnings on reserves for 1980 was approximately equal to the amount accrued in Federal income tax by commercial banks. These earnings on reserves, therefore, should be taken into account whenever the effective Federal tax rate is discussed.

It would be less than candid for me, however, not to discuss the additional element that for many banks reduces the effective rate of Federal income tax calculated as a percentage of total pre-tax income. I am speaking of income from state and local obligations which, as you know, is not subject to tax under the Internal Revenue Code. Calculated as a percentage of gross income, bank earnings from state and local obligations have been dropping steadily over the past six years, from 7.4 percent in 1975 down to 4.3 percent in 1980. FDIC 1980 Annual Report, Table 115. The trend is actually sharper than it appears, as earnings per $100 of investment in these obligations has increased over the same period from $4.97 per $100 in 1975 to $5.86 per $100 in 1980. Ibid. As a percentage of total assets, state and local obligations amounted only to slightly less than 8 percent in 1980, but the effect these assets had on earnings was disproportionately large due to the high operating expenses incurred by banks during 1980.

In summary, it is clear that commercial banks have borne their fair share of the corporate tax burden based upon corporate taxable income. Commercial banks, in addition, have provided, through the Federal Reserve System, an equal contribution to the Treasury as earnings on reserves invested by the Federal Reserve. It is only when their tax-exempt income is taken into account and the Federal Reserve earnings on reserves are ignored that the effective rate of Federal income tax for commercial banks—as a percentage of all earnings—is reduced to a level at which the proposed alternative minimum tax begins to bite.

The reduction of banking's effective tax rate is not, therefore, attributable to "the use of special types of financial arrangements or legal devices (which) allow one taxpayer to pay a much lower tax than similar taxpayer engaged in exactly the same activity", as Secretary Regan characterized the "abuses" the tax proposals are designed to eliminate. It is, in large measure, simply the result of commercial banking's traditional function as substantial purchasers of state and local debt at yields below those the governments would have to pay on bonds subject to Federal tax.

RELATIONSHIP BETWEEN INTEREST RATES AND BANK EARNINGS

It goes without saying that we are all concerned about the present rates of interest. What is of great concern to me and to the American Bankers Association, is that there is a public misconception that banks are either responsible for these rates or that banks benefit from them.

Chart 1 compares interest rates and commercial bank profitability over the thirty years from 1950 to 1980. As you can see, net income after tax as a percentage of assets for commercial banks has held relatively steady, while interest rates have moved sharply upward. Table 2, based on Forbes Magazine's annual survey, compares the profitability of banks with the profitability of other industries. Bank profits, as compared with other industries' profits, have steadily declined since 1970. Although there are many factors involved in profitability, including declining deposit base and the expenses of the new technology needed to provide the convenience and security bank customers deserve, the increase in the cost of funds to banks is perhaps the single most important factor in increased costs and lower profitability.

ALTERNATIVE MINIMUM TAX FOR CORPORATIONS

The largest single revenue increase in the Administration's proposal would come from an alternative minimum tax for corporations. The current minimum tax would be repealed and replaced in 1983 with a tax of 15 percent on corporate taxable income, determined without regard to the net operating loss deduction, plus certain tax preference items. Banking is singled out for the largest increase in corporate tax burden (53 percent), followed by the petroleum industry (both refining and extracting) at 27 percent, and the utility industry at 15 percent. The largest share of the increase in banking's income tax burden appears to be attributable to the inclusion in the minimum tax base of a portion of total interest expense attributed to support of tax-exempt investments. Other tax preference items affecting banking are:

(1) Loan loss reserves in excess of those determinable under the experience method. This is the same item as in current law but would have greater impact due to the way this tax is computed.

(2) Lessors' leasing benefits.

(3) Excess interest deductions on original issue discount obligations.

The only credit allowable against the tax would be the foreign tax credit, limited to taxes paid on preference-related foreign source income and creditable only to the extent that the taxes were not imposed at a rate higher than 15 percent. A minimum tax credit—the excess of minimum tax over regular tax—would be carried forward against future regular tax liability.

You will by now have heard from serious and articulate critics of the proposed alternative minimum tax. We, too, would urge you to examine alternatives for increasing revenue carefully. Rather than discussing the relative merits of the minimum tax approach, however, we believe that it might prove more constructive and more useful to you to point out what the ABA believes to be unintended effects certain aspects of the minimum tax proposal will have unless the proposal is abandoned or modified substantially.

TAX PREFERENCE ITEMS—INTEREST ON INDEBTEDNESS TO CARRY TAX-EXEMPT SECURITIES

Among the tax preference items listed in the Administration's minimum tax proposal, this item, described as "deductions for debt to carry tax-exempt securities" is clearly of greatest concern to banks. It is even more important to state and local governments.

Under section 265(2) of the Internal Revenue Code of 1954, a taxpayer may not deduct interest paid on debt incurred to purchase or carry tax-exempt obligations. The Treasury Department's technical explanation states that the normal rule of section 265(2) does not apply to commercial banks, or to other financial institutions having less than 15 percent of their total assets invested in tax-exempt obligations.

This matter has been the subject of a number of controversies between banks and the IRS over the past sixty years. Perhaps the best explanation of why section 265(2) has not been applied to banks' interest expense is IRS's own explanation in Revenue Procedure 70-20 which was issued for the purpose of setting forth guidelines for taxpayers and the IRS for the application of section 265(2) to banks holding state and local obligations: "It is clear from the legislative history . . . that Congress intended to disallow interest under such section only upon a showing of a purpose by the taxpayer to use borrowed funds to purchase or carry tax-exempt securities. It is clear that indebtedness incurred by reason of deposits in a bank is not incurred to purchase or carry tax-exempt securities. The Congress has repeatedly recognized that indebtedness incurred by a bank to its depositories is not to be treated as indebtedness incurred or continued to purchase or carry tax-exempt securities. . . To do so would seriously interfere with the marketing of government securities, which are bought for the most part by banks. . . The primary purpose of a commercial bank is to make available to one segment of society money which is excess to the current needs of other segments of society. Because a large part of its indebtedness is subject to payment on immediate and short-term demand as contrasted to the money it lends, it must have considerable flexibility as to the source of its funds." The Revenue Procedure concludes by holding that "section 265(2) should not be deemed applicable to interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. . . A direct connection will not be inferred merely because tax-exempt obligations were held by the bank at the time of its incurring indebtedness in the course of its day-to-day business."

In December, 1980, the IRS issued Revenue Procedure 80-55, which would have denied banks a deduction for interest paid to state and local governments on deposits secured in accordance with state and local law by tax-exempt securities. In March, 1981, the Commissioner of Internal Revenue and the Assistant Secretary of the Treasury for Tax Policy withdrew the revenue procedure and announced that the revenue procedure "failed to give adequate consideration to the basic treatment accorded bank deposits under the longstanding administrative interpretation of section 265(2)".

There is, it may be argued, no exception for banking from this general rule. As with all other taxpayers, section 265(2) denies banks the deduction for interest on debt incurred to purchase or carry tax-exempt obligations. As noted by the Commissioner and the Assistant Secretary in their joint statement, section 265(2) will be applied "to interest paid on deposits which are incurred outside of the ordinary course of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations." This is consistent with case law and IRS rulings spanning the period from 1917 to the present and this in-

terpretation of the statute has been reaffirmed by the Congress on numerous occasions.

The inclusion of this item in the minimum tax base arbitrarily treats a portion of a bank's cost of funds—its chief cost of doing business—as incurred to purchase or carry all tax-exempt securities held by it, and applies the minimum tax rate to some portion of the bank's interest deduction. This goes far beyond the rule of section 265(2) by establishing, in effect, an irrebutable presumption that a bank incurs a portion of its current interest expense for the purpose of carrying tax-exempt securities regardless of yield or date of purchase. Furthermore, the Technical Explanation gives no guidance as to how this allocation of interest expense is to be made.

Banks purchase tax-exempt securities for a number of reasons. Commercial banks have traditionally provided 40 to 60 percent of the market for state and local bonds. As explained by a recent treatise on municipal bonds:

"Commercial banks are heavy buyers of municipal bonds when their loan demand is relatively soft and credit is readily available, beginning usually when the economy is slack and interest rates are low, and continuing well into the next business cycle expansion. Demand for business loans generally gathers strength late in a business cycle. As loan demand picks up steam and credit generally tightens, the banks slow their buying of municipal bonds and some liquidate portions of their holdings. This pattern has been followed fairly consistently in the post World War II period.

* * * * * * *

"Commercial banks usually invest in municipal securities of short and medium-term maturities to assure themselves liquidity. Commercial banks also own municipal bonds to pledge as collateral for public deposits. In addition, municipal bonds can be used for collateral at the discount window of the Federal Reserve." Fundamentals of Municipal Bonds, Public Securities Association, New York (1981), pages 96, 97.

Approximately 35 states, and many local governments, require banks to secure public deposits in whole or in part by bonds issued by the state or local government involved, federal securities, or similar high grade forms of collateral.

In addition to supporting the community in which a bank operates, the purchase of relatively low-yielding bonds may be viewed as an indirect tax payment to the issuer. That is to say that the lower yield on the bonds results in lower costs to the government issuing them. This is more efficient economically for the issuer than issuing higher yield taxable obligations and then collecting tax on that income.

The Committee should be aware that the application of this item to existing portfolios has an inherently retroactive effect. Long-term low-yield securities purchased years ago have a current market value well below the price at which they were purchased. In that respect, these securities are to commercial banks what low yielding mortgages are to savings and loan associations. That is, they could be sold on today's market only at substantial loss to the institution. To change the rules applicable to these investments made in the past, under established and well recognized rules of taxation, would be unfair. It would also make what may be viewed in retrospect as a bad investment, because of low yield and low market value, worse because the bonds would now attract minimum tax liability.

This Committee should consider carefully the impact of, in effect, eliminating at least 40 percent of the market for these bonds at their currently lower-than-taxable yields. Banks and other purchasers of municipal securities probably would not cease to purchase them altogether, but the yields would have to increase to make them marketable. Preliminary estimates of the impact this would have on the tax-exempt bond market suggest that it would result in an increase in borrowing costs to state and local governments of as much as 220 basis points (2.2 percent) in yield. This increase in financing costs for state and local governments would come at a particularly tough time, as those levels of government are being asked to shoulder more of the burden of programs which have been carried out by the Federal government. In addition to requiring increased state and local taxes to support the more expensive issues, this action could increase the financing costs for large municipal projects to unacceptable levels, resulting in additional unemployment, with its consequent costs to Federal, state, and local governments.

Finally, it should be pointed out that this is one of only a few items in the Administration's minimum tax preference item list which is not a timing difference. With, for example, the excess percentage loan loss reserve addition item, one can view the minimum tax as the cost to the taxpayer of taking a deduction earlier than it would otherwise be allowed. This item is completely different. It not only represents a substantive change in a long standing United States tax policy, it has serious conse-

quences for persons other than the taxpayer directly affected. The ABA believes it is bad policy and goes beyond a termination of the rule applied to commercial banks under section 265(2) for over half a century, a rule reaffirmed by the Congress on numerous occasions.

RESERVES FOR LOSSES ON BAD DEBTS OF FINANCIAL INSTITUTIONS

The inclusion of the amount by which a bank's deduction for additions to its loan loss reserve under the percentage method exceeds the amount deductible under the experience method as a tax preference item is consistent with its treatment under the current minimum tax. Due to the way in which the alternative minimum tax would be computed under the Administration proposal, however, the impact would be greater than under the current minimum tax. Ironically, this would take effect just as the percentage provided for additions to the loan loss reserve will drop from 1.0 percent, as provided by the Economic Recovery Tax Act of 1981, to .6 percent, and at a point in the current business cycle at which loan losses are increasing to levels in excess of the expiring percentage method amount for many banks.

Although the Administration's tax proposals do not include a change in the scheduled drop in the percentage, the ABA believes that the present percentage level for loan loss reserve additions should be preserved and, in fact, should be increased. While the level of losses for the banking industry as a whole amounted to approximately one-half of the maximum rate of allowable reserve additions provided by section 585 for 1976 through 1981, many banks experienced losses equal to or greater than the 1.2 percent level in effect for 1981. Considering the function of the loan loss reserve, it would seem timely for the Congress to review the determination made in the Tax Reform Act of 1969 to place banks on the experience method by 1988. Consideration should be given also to the elimination of the loan loss reserve provision from the list of preference items under the current or proposed minimum tax. It should be noted that, particularly in light of loan losses experienced during the current economic decline, bank regulatory agencies are encouraging banks to increase their loan loss reserve provisions in order to diminish the risk of severe economic reversals from the cumulative effects of nonperforming loans due to current business failures, which are reported to be at the highest levels since World War II.

EXCESS ORIGINAL ISSUE DISCOUNT INTEREST

Under regulations issued by the Internal Revenue Service under section 1232 of the Internal Revenue Code of 1954, both cash basis and accrual basis banks deduct interest payable on an instrument issued at a discount and having a maturity of more than one year on a pro rate basis over the life of the instrument. For financial accounting purposes, however, a bank may charge its interest expense account by a method which produces, on a compounding basis, the same amount of interest over the term of the instrument as will be payable as original discount interest. It is this difference between financial and tax accounting that creates this "preference". A better approach to this difference between financial accounting and tax accounting, the ABA believes, would be to permit conformity between financial accounting and tax accounting. That is to permit bank tax accounting to follow financial accounting in this instance rather than penalize banks for following IRS requirements under the section 1232 regulations.

TREATMENT OF NET OPERATING LOSSES

Under the Administration's proposal, the net operating loss deduction is disregarded in determining the minimum tax base and is treated as absorbed by the minimum tax through the minimum tax credit mechanism. Under the current minimum tax, the minimum tax liability is deferred if the taxpayer has a net operating loss for the year any part of which is carried over to the next year. This seems a much fairer way of treating companies with a net operating loss for the taxable year. This is especially important for banks and other financial institutions during a period in which healthy institutions are being asked to pick up financially troubled institutions through acquisition and merger. The ability to use the acquired institution's net operating loss is usually an economically significant part of the inducement for the healthy institution to enter into the transaction. Note, for example, that the Economic Recovery Tax Act of 1981 amended the Internal Revenue Code to permit net operating loss carryovers in supervisory mergers of troubled thrift institutions to be used by the surviving institution without regard to the continuity of interest limitations otherwise applicable. Further, if the item relating to tax-exempt

bonds held by commercial banks is included in the minimum tax base, it would be impossible for a bank to avoid the minimum tax without selling its tax-exempt portfolio and any such sale would be at loss levels likely to produce a net operating losses which would have to be carried over to other taxable years. Since the minimum tax would disregard the net operating loss deduction, the bank would be trapped either way and probably exposed to minimum tax for years in which it otherwise would not be affected by the minimum tax. This feature would complicate unnecessarily multi-year calculations arising out of net operating loss carrybacks and would result in a nightmarish series of redeterminations each time there was a net operating loss carryback.

WITHHOLDING AT SOURCE ON DIVIDENDS AND INTEREST INCOME

The ABA is opposed to the Administration's proposal to institute a system of withholding at source on dividends and interest income. This proposal, if adopted, would require banks and other financial intermediaries to withhold 5 percent of the income earned on all types of financial instruments, to remit these monies to the Treasury, and to document such transactions with information returns supplied to the Internal Revenue Service and to the customer. These requirements, though superficially facile, are complex, costly, and time consuming to both the bank and the customer. These requirements would deter savings, impose substantial cost burdens on the public and would not apply fairly to all taxpayers. In addition, the proposal is contrary to the Reagan Administration's program to reduce federal paperwork requirements.

Mr. Chairman, the ABA strongly supports the efforts of the President and the Congress to promote economic development and balance the budget through fiscal restraint. If inflation is to be cured it is essential that the federal budget be brought into balance and savings and investment be increased to enhance productivity. Bankers are committed to the achievement of this goal and we will do all in our power on its behalf.

The ABA also strongly agrees with the Treasury that increased incentives must be developed to encourage further taxpayer compliance with the tax laws and reduce the magnitude of the underground economy. The ABA vigorously supports efforts to develop incentives to encourage taxpayers to voluntarily and fully report their income. The Association and its members have worked diligently over the years to improve the current information reporting system, both the bank operations and the internal IRS procedures.

The increasing disrespect for the voluntary nature of our tax system is undermining its very feasibility. Imposing universal withholding will only further reduce "voluntary" to a hollow, meaningless word, a mere facade for what is really a compulsory system. Other more palatable mechanisms must be developed. The ABA stands ready to assist the Treasury and the Congress to explore the possibilities.

Withholding is not the answer to the question of how to balance the budget nor the question of how to encourage taxpayers to disclose their income more fully.

COST OF WITHHOLDING

Withholding on interest and dividend income is not a new idea. It has been proposed several times before and has always been soundly rejected, the last time being as recently as two years ago. At that time, the ABA commissioned a study of the feasibility of the proposal and its cost to the Treasury, to the banking system and its customers. This study, conducted by Arthur Young and Company, a national accounting firm, concluded that the revenue gain estimates were probably overstated, and the costs to the Treasury to implement the system and process the increased number of forms (estimated to be 250–300 percent greater than currently required) were understated.

In its explanation of the withholding proposal, the Treasury Department observes that the current information reporting requirements are inadequate to ensure full compliance in reporting interest and dividend income. Thus the desire to clamp down on the underground economy prompts this administration, like others before it, to suggest extending withholding beyond the current wage system to interest and dividends.

Presently, information reporting is required as to payments of interest on deposits aggregating $10 or more. The withholding applies to all payments of interest to individuals—no floor amount. Thus withholding would be required on accounts for which no information return is required. It is easy to see that the proposal vitiates the $10 floor for information returns, making them mandatory for even the smallest amount.

Many financial institutions report interest payments by magnetic media to the IRS, and are able to meet the requirement to provide a written statement to their customers by showing the aggregate amount of interest paid on year-end statements. If information Forms 1099 are required to be attached to tax returns to verify credit claims (similar to the case of wage withholding and the W-2), depositories will be required to generate millions of additional paper documents, substantially adding to present information reporting costs.

It is widely known that the IRS currently has massive problems with its matching program. It does not now have the capacity to process with the degree of reliability and accuracy necessary the volume of information returns it receives. The proposal will only increase by several fold the number of forms sent to the IRS, thereby exacerbating the problem, not alleviating it.

The study found the costs to the banks to be substantial that these costs would be passed on to the consumer in the form of lower interest rates for depositors, higher interest rates for borrowers, or higher fees for servicing accounts. Because of the high costs of savings account administration, many banks are presently (or are considering) not taking small accounts, charging monthly or quarterly service fees for small accounts, or not paying interest on such accounts. With the additional costs of withholding, maintenance of exemption certificates, and increased information reporting, an even greater number of financial institutions are likely to discontinue the acceptance of small accounts or to raise the minimum balance requirements or charges. In many banks, withholding would drive these small accounts out of existence. In addition, efforts to provide returns on previously non-interest bearing deposits (transaction accounts such as NOW accounts, share drafts, and automatic fund transfers) would be thwarted by higher transaction charges or minimum balances in order to cover the costs of withholding.

Unlike wage withholding, which applies evenly to all employers, the burden of withholding on dividends and interest will be concentrated on financial institutions, particularly full service banks. This is because of the wide range of depository, fiduciary, and financial agency services which commercial banks offer to their customers.

A typical bank may offer the following interest bearing accounts or instruments:

(1) Regular passbook account.
(2) Christmas Club account.
(3) Time deposit, 30 month.
(4) Time deposit, 4 years.
(5) Time deposit, 6 years.
(6) Money Market certificates.
(7) Negotiable certificates of deposit.
(8) Bankers acceptances.
(9) Repurchase agreements.
(10) NOW accounts.

The typical bank also may collect or redeem the following in an agency capacity, normally as an accommodation for customers at cost:

(1) Corporate bond coupons
(2) Series E and EE bonds
(3) Government and government backed securities, (T-bills, GNMAs, etc.)
(4) Commercial paper

The typical bank with a trust department may offer these personal and corporate trust and financial services:

(1) Paying agent for dividends.
(2) Paying agent for registered bonds.
(3) Paying agent for bearer bonds.
(4) Personal trusts.
(5) Investment Management accounts.
(6) Custodial accounts.
(7) Dividend reinvestment agent.

The list in each area could be expanded because each bank offers a range of services tailored to meet its individual customer needs.

This wide variety of savings instruments offered, as well as the broad range of fiduciary and financial collection and agency services, necessarily makes the task of complying with the demands of the withholding proposal complex and costly.

The start-up costs would include: (1) reprogramming in the areas where there is already information reporting to compute and deduct the 5 percent withholding, to aggregate the amounts withheld for payment to the government and report the tax withheld to the customer and the government; (2) developing new programs for withholding and reporting in areas where information reporting is not applicable

currently; (3) if annual withholding is chosen, developing a program to insure that account balances do not fall below the amount of deferred withholding; (4) establishing an exemption certificate mechanism and procedures for obtaining, coordinating, storing, etc.; and (5) determining which accounts are exempt either because there is a certificate, its principal is tax-exempt, or its principal is a corporation.

Costs will vary depending on the degree of automation in the individual banks as to the various services provided. Problems will arise as to those institutions which maintain an extensive branching system. In some cases, a number of depositories may own a service corporation which provides data processing for its owners. In some cases, banks may provide this type of service for a number of correspondent banks, or an independent data processor may serve a number of institutions. In any case, the necessary costs for reprogramming, retraining personnel, preparing forms, and educating customers will be very extensive as to every institution.

The Arthur Young accountants studied the cost of the implementation and the annual operating costs of a withholding system. The results, detailed in the attached report, indicate the costs to the financial system to be from tens of thousands to even a million dollars per bank. The results also indicate that the costs would be unevenly spread across the industry, hitting the small, community bank more heavily, and would change the relative competitive position of various banks accordingly.

The withholding proposal attempts to mitigate some of the burdens on financial depositories by providing an option to the institution to withhold annually, regardless of when interest is posted to a depositor's account. If such option is exercised by many, then it obviously would reduce substantially the additional revenue for 1983 estimated to be derived from the acceleration of tax payments through withholding. However, it appears that this provision may be of limited utility to depository institutions since any deferred withholding tax would be due when an account is closed and depositories would be required not to allow account balances to fall below an amount equal to the deferred withholding. Without a disclaimer or warning on account statements or other notices of account balance, the depositor would be misinformed as to his current balance of funds available for withdrawal, and the institution might be subject to liability. Also without deductions and notice of withheld taxes, it is likely that many persons with NOW accounts, share drafts, and ATS arrangements might write checks or share drafts that would be dishonored because of this minimum balance requirement.

The tax code allows a holder of Series E bonds to report interest annually and pay the tax liability. Under the proposal 5 percent of total interest is to be withheld when the bond is redeemed. Thus, this could result in a withholding for tax already paid. Many types of interest-bearing deposit accounts provide penalties for early withdrawal. Withholding presumably would have been applied to the higher rate. If a person withdraws and the penalty is applied the amount already withheld may well exceed the tax owed.

EFFECT ON SAVINGS

All of these monetary burdens, inequities, and inconveniences are bound to slow our current savings rate even more.

There is a theory expressed by some that except for the lost interest on interest and the amounts which non-taxpayers fail to recover through refunds, the remainder of the amount withheld will find its way back into savings and investment if the taxpayer would have otherwise left them in savings and investment. This theory ignores human nature and the current savings environment. Many savers set aside so much each pay period and budget themselves to live on the remainder of their wages, including payment of their income taxes. Sometimes it is difficult, but they are reluctant to invade their savings including earned interest. On the other hand, if 5 percent is withheld and subsequently refunded in whole or in part it is easier to consume. Likewise, current earnings that might otherwise have been used to pay tax liability arising from savings will be consumed.

Supporting the human nature response to the theory is the fact that the withholding may have come from interest on a two and one half year time deposit or other type deposit requiring minimum size and the refund would not be large enough to deposit at the higher rate. Thus the incentive to save would be diminished.

The same result occurs but with more certainty in the case of dividend reinvestment plans. Under such a plan the investor makes a decision to save by reinvesting automatically his or her dividends in more company stock. The saver is encouraged to do this by lower or no brokerage costs, and possibly a discount price from the market price. If 5 percent of the dividend is withheld there will be a 5 percent smaller investment and, unless the plan has a provision for participants to invest

additional funds, the saver is forever foreclosed as to the 5 percent withholding of enjoying the plans' investment incentive.

Clearly, this will have an adverse impact on our nation's economy and our efforts to raise capital. To the extent that dividend and interest income is not consumed currently it will reduce the amount reinvested up to 5 percent. It would eliminate the capital growth that would result from the interest that would be earned on the interest withheld. It would also lower in other ways the effective yield on savings and consequently reduce the flow of funds into savings instruments.

As is discussed elsewhere in this statement, withholding would require the use of substantial additional private sector resources to pay for tax collection. To the extent these resources could otherwise be put to productive use, production, and therefore by definition productivity, would be lowered accordingly.

The Congress is clearly aware of the shamefully low savings rate in this country. Recognizing that this rate must be dramatically increased, last summer the Congress passed and the President signed the Economic Recovery Tax Act of 1981. ERTA contained several provisions designed to encourage those who do not save to do so, and those who are already saving to save a little more. The withholding proposal reverses this effort by reducing real savings, by draining 5 percent of the earned interest out of the interest earning stream at each crediting date, thereby lessening the compounding factor under which most interest is computed.

OVERWITHHOLDING

The study also concluded that the public will incur increased overwithholding of income taxes. Taxes are already overwithheld on more than three-quarters of individual tax returns; additional withholding is not necessary. Though the proposal states that individuals could avoid overwithholding on interest and dividends through adjustment of their wage withholding statements (W-4s), it is clear that taxpayers are already not availing themselves of that opportunity for wage withholding and are unlikely to do so for interest and dividend withholding. The sophisticated saver with large amounts of interest and dividend income will be savvy enough to adjust wage withholding to avoid overwithholding on total income. But the average small saver will not have the tax planning acumen to do so—and as a result it will be the "little guy" who will end up giving another interest-free loan to his Uncle Sam.

EXEMPTION CERTIFICATES

The withholding proposal, in an attempt to provide equity, allows the filing of exemption certificates by those who anticipate no income tax liability. These certificates would escalate the cost of withholding many times. They must be handled manually and stored for retrieval. Bank personnel would have to be trained to handle customer questions concerning their eligibility for an exemption. Individual certificates would have to be filed for each account.

It would be relatively easy mechanically to secure the execution of an exemption certificate when accounts are opened or shares are acquired, but this is normally done during taxpaying years. It is the elderly, who already have their accounts, and who rely most heavily on interest income for support, who would need to file the certificates. Processing certificates for existing accounts would be very costly and required substantial lead time to implement. In addition, who is going to inform our senior citizens that they are going to lose 5 percent of their income unless they file an appropriate number of exemption certificates or file a refund claim? Who is going to explain the law and see they are protected?

Again, it is important to recognize that withholding would apply to a variety of depository accounts such as regular savings accounts, club accounts, certificates of deposit, time-open accounts, and special notice savings accounts, all of which pay interest on a periodic basis. Depositories also issue and redeem short-term certificates such as money market CDs, which pay interest only at maturity. While some banks' recordkeeping systems may allow the use of a single exemption certificate for depositors with more than one account, it is probable that in most cases separate certificates may be required for each account. Similar problems may arise in the case of certificates of deposit which are renewed or rolled over at maturity. Certain types of interest payments, such as corporation bearer bonds with coupons and short-term money market discount obligations, may require certificates for each transaction unless there is a continuing relationship with the same institution.

Depository records, such as ledger cards or program codes, would have to be updated periodically to reflect a changes in status. It is also unclear whether withholding would have to be adjusted to reflect change in status. Further cost would be in-

curred in providing copies of the certificates to the IRS and for storage and retrieval of copies in response to examination of the taxpayer or the paying institution.

It is important to recognize that many interest payments by depositories, other than those covered by exemption certificates, will not be subject to withholding, such as payments to corporations, tax-exempt organizations and non-taxable accounts (such as deposits of non-resident aliens and foreign residents and IRA and Keogh accounts). Therefore, depositories would be required to review all existing accounts to determine if withholding will apply to the payee.

As referenced before, withholding on deposit accounts is only one of the numerous ways in which withholding-at-source would affect commercial banks. Banks would be required to withhold on dividends paid to their own stockholders as well as interest paid on their capital notes and debentures. Banks would also have to withhold with respect to (1) stock dividends and interest on registered and bearer obligations including bond coupons of other corporations for which they act as paying agents, (2) government and agency obligations, and other discount money obligations presented to them for payment or collection, (3) redemption of United States savings bonds, and (4) the distribution of income to trust beneficiaries for whom they act in a fiduciary or custodian capacity. Some special problems of each are discussed below:

TRUST OPERATIONS

Some 4,200 banks in the country have trust powers and administer more than one million personal trusts and estate accounts, providing services for many millions of individual beneficiaries who would be subject to withholding on trust distributions of income from interest and dividends. In addition, banks maintain another 150,000 agency accounts where stocks and securities are held in nominee form.

Many beneficiaries of personal trusts are low-income or nontaxable individuals, such as retirees, widows, and children. Banks exercising trust powers would have to secure exemption certificates from these beneficiaries in order to avoid overwithholding.

A bank trust department may find it difficult to determine whether they are distributing dividend and interest income or income from another source. Do they follow Lifo or Fifo procedures? Can they arbitrarily select which type income to distribute? Will the government define which income is to be distributed first or to whom? What about distribution of accumulated income where the income tax has already been paid by the trust? There are many more unanswered and possibly unanswerable questions.

INTEREST AND DIVIDEND PAYING AGENTS

The work of banks acting as dividend paying agents will be complicated in several ways. Extensive computer reprogramming will be required to inform stockholders of the gross dividend, the amount of tax withheld, and the net dividend paid. There would be additional problems where a dividend is paid partly from income and partly from capital or where a corporation makes a dividend distribution in kind. Similar reprogramming will be necessary for registered securities such as corporate bonds. It has been suggested that our experience in withholding on non-resident aliens proves it can easily be done but such withholding has applied to about one half of 1 percent of accounts and has been done for the most part manually.

Interest coupons on corporate bearer bonds are clipped by the owners and cashed or deposited at a bank. The bank is responsible for verifying and totaling the coupons and then must obtain reimbursement or collection through banking channels. Presumably, the paying bank would be responsible for deducting tax from the coupon, information reporting to the owner and the IRS, and the handling of exemption certificates in each case.

U.S. SAVINGS BOND REDEMPTIONS

Presently, many financial depositories act as paying redemption agents for U.S. Treasury savings bonds, with banks alone accounting for 92 percent of bonds paid. In calendar year 1979, over 170 million bonds were redeemed; for the first quarter of 1980, there were 68 million redemptions. In effect, withholding or an exemption certificate would be required as to each bondholder, and, additional information reports would be required for these payments. This would require the establishment of an account for each person who redeems a bond. This increase in costs to the bank for redeeming savings bonds would have to be passed on to the Bureau of the Public Debt or many institutions would cease handling redemptions.

TREASURY AND MONEY MARKET BEARER OBLIGATIONS

Another class of withholdable payments to which information reporting does not currently apply is marketable U.S. Treasury debt. While a substantial portion of the estimated 34 billion dollars held by individuals is in registered form or held in book entry accounts at the Treasury, approximately half of such volume is held in book-entry accounts at banks and securities dealers or is in bearer form. A rough estimate of individual holders is 8 million. Banks will also be required to withhold and report for an undetermined number of individuals holding commercial paper, for which banks act as issuing or paying agent; U.S. agency and Farm Credit system bearer or book-entry obligations; and banker acceptances. While individuals hold a small percentage of the dollar volume of these obligations, they represent as much as 30 percent of transactions. Again, each transaction requires withholding or an exemption certificate and the establishment of an account for reporting to the government and the customer.

IMPLEMENTATION TIME

Should the congress adopt the withholding proposal it will take many banks many months to implement the program even if they gave it the highest priority, setting aside their efforts in other areas. It would be impossible to be ready by January 1, 1983. The task is just too big.

INCREASED REVENUES TO THE TREASURY

The Administration estimates that the proposal will result in increased revenue of 500 million in fiscal year 1983, $1.1 billion for fiscal year 1984, $1.2 billion for fiscal year 1985, $1.4 billion for fiscal year 1986, and $1.5 billion for fiscal year 1987. When the Arthur Young Company studied the revenue estimates given for the Carter withholding proposal, they questioned the reliability of the estimates and suggested the actual revenue gains would be substantially less. The figures given for the Reagan withholding proposal are presumably no more reliable than those given two years ago. It should be noted that withholding may not provide any significant collection of tax revenue from the willful non-filer. Through such devices as misuse of exemption certificates, shifts to nonwithholding investments, the willful noncomplier will continue to avoid tax payment.

EFFICIENCY OF TAX COLLECTION

Arguments have been made to support withholding over information reporting as an effective means of insuring compliance and collection of tax. First, much of the nonreporting is due to inadvertence. It is argued that the use of information reporting and audit procedures to close the nonreporting gap would require millions of phone calls, letters and visits, many involving small amounts of tax, which would be regarded as harassment of "little people". Is not the imposition of withholding on small interest or dividend payments whether or not there would be tax liability, the requirement to file an exemption certificate and the potential increase in over-withholding of tax an even more direct and burdensome form of government harassment? And in any case, the burden of collecting those small amounts of tax does not disappear through the institution of a withholding system; it is merely shifted from the government to the financial institutions of this country.

Overwithholding has been a source of controversy for some years now. The Comptroller General of the United States, in a 1980 letter to Representative Benjamin S. Rosenthal, updated a 1977 report detailing "Inequities in the Federal Withholding Tax System". This letter indicates that in spite of Treasury and IRS efforts to educate employers and employees and to improve withholding tables, the present wage withholding system results in "overwithholding for 80-90% of taxpayers subject to withholding." Moreover, the amount of tax overwithheld appears to have substantially increased. Withholding on dividends and interests will further promote overwithholding as to most payees of interest and dividends.

The report further notes that such wage withholding comes from the complexity of the tax laws which results in the failure of individual wage earners to claim the full number of exemptions available. Yet, the Treasury has suggested that the overwithholding as to interest and dividends could be cured by individuals reducing the amount of tax withheld on wages. Second, the letter notes the cost of following up millions of apparent discrepancies would be uneconomical and such enforcement effort could not be reconciled with any sound concept of tax administration. The cited IRS report establishes that the vast majority of American taxpayers do pay their tax liability with respect to interest and dividends, reporting between 84 to 91

percent of such amounts. Is it efficient tax administration to impose a withholding system on the vast majority of such taxpayers who pay their full tax liability, in order to ensure some measure of collection from the small number of persons who by inadvertence fail to pay their tax liability? As to the willful nonfiler, the present collection program must be maintained because, as mentioned before, he will avoid withholding or at least paying any more than what is withheld.

Withholding at source will ensure collection of 5 percent as to all taxable payments of interest and dividends, but it will not alleviate or relieve the need for a full matching program for information reports and a collection effort as to unreported or unpaid amounts. In fact, with the expansion in the number of payments subject to information reporting and withholding, the number of information returns requiring processing will be substantially increased. The introduction of the exemption certificate program provides an opportunity for abuse. Therefore, the IRS would be required to match all information statements that do not report any tax withheld with taxpayer returns or attempt to verify whether the taxpayer was a legitimate nonfiler in cases where no return was filed. Matching would also be required to determine if tax liability was fully paid in cases of taxpayers with effective tax rates higher than 5 percent. Obviously, the same problems as to securing responses to IRS inquiries and to collect amounts when deficiencies are determined will still prevail. In discussing the efficiency of withholding over information reporting there is a failure to address the lack of economy where billions of dollars are overwithheld and must be refunded, and millions of taxpayers suffer a loss of earnings through the acceleration of their tax payments and such overwithholding. Third, the letter cites that failure of payors to comply fully with information reporting requirements limits the use of information statements. The same problem will still exist unless the additional burden of withholding would make payors more meticulous. With withholding mistakes the taxpayer would more often be the one prejudiced. Finally, the letter notes that extensive pursuit of taxpayers does not achieve full collection where taxpayers cannot be traced or where it is uneconomic to collect taxes even if they have been assessed. Admittedly 5 percent tax is better than nothing, but we repeat compliance efforts would still have to be maintained to collect any additional amounts due above 5 percent or all the tax due from taxpayers wrongfully filing exemption certificates or using other withholding evading practices.

TAX EQUITY

The Treasury states that interest and dividend income is essentially the same as income from wages, and the recipients thereof should pay their taxes with no less certainty and just as promptly. The application of withholding at source to wage payments, adopted in 1962, represented a drastic departure from our system of self-assessment. It was generally accepted by the public because wage payments usually involve a single employee in direct relationship with his employer. Wage withholding provides a mechanism for claiming all deductions, exclusions, exemptions and credits against such income. In contrast, withholding of interest and dividends involves a more remote relationship with potentially large numbers of payors of interest and dividends. Moreover, there is no mechanism for the allowance of deductions, etc., which would prevent over-withholding of tax. Quarterly estimated payments of tax assures prompt payment of interest and dividends, and effective utilization of the information reports provides a mechanism to determine whether tax is being fully paid with respect to such payments.

It has been noted that failure of some taxpayers to report interest and dividend income diminishes respect for and jeopardizes our system of voluntary compliance. So the Treasury suggests we cope with this jeopardy to our voluntary system by adopting a mandatory system. The public acceptance of wage withholding arises from a recognition that is is a desirable means to pay taxes when due. This rationale is inapplicable to interest and dividends. Those subject to such withholding are already voluntary savers, and the withholding, in fact, is a penalty because it reduces earnings on their present savings and investments. The ability to pay tax when due usually is not a problem for the taxpayer with a savings base, as well as currently generated income. The lack of respect for our tax system arises from its complexity and the failure of the IRS to consistently enforce the tax laws—not be the institution of a complex, compulsory system that says that the average taxpayer is unwilling or incapable of reporting tax due.

Mr. Chairman, the American Bankers Association urges the Congress to reject the proposal for withholding on dividend and interest income at the source. It would be extremely costly to the taxpayer and to the economy. The present system of infor-

mation reporting and audit should be made more effective by an improved matching program. The ABA would be happy to work with the Congress and the Administration toward that end.

TAX EXEMPT BONDS FOR PRIVATE ACTIVITIES

The American Bankers Association supports the concept of the Administration's proposals restricting the use of tax-exempt bonds for private activities. The seemingly uncontrolled growing use of this type of financing for commercial as well as industrial and manufacturing development is putting increasing pressure on municipal bond prices and increasing rates governmental units must pay for capital financing of more traditional purposes.

The relationship of "public purpose" to tax-exempt financing is one of perception and controversy. We cannot arbitrate what projects should or should not be tax-exempt or who should or should not enjoy tax-exempt status. We feel the approriate scope of "public purpose" is a question which can only be answered legislatively.

We view the continued excessive use of tax-exempt issuance as troubling, disruptive, and detrimental to the municipal market. The value of the tax exemption is being destroyed. This is why we support the concept which the Administration is proposing and urge this Committee to act to restrict the issuance of tax-exempt bonds for private purpose.

TABLE 1.—1977 STATISTICS OF INCOME—CORPORATION INCOME TAX RETURNS

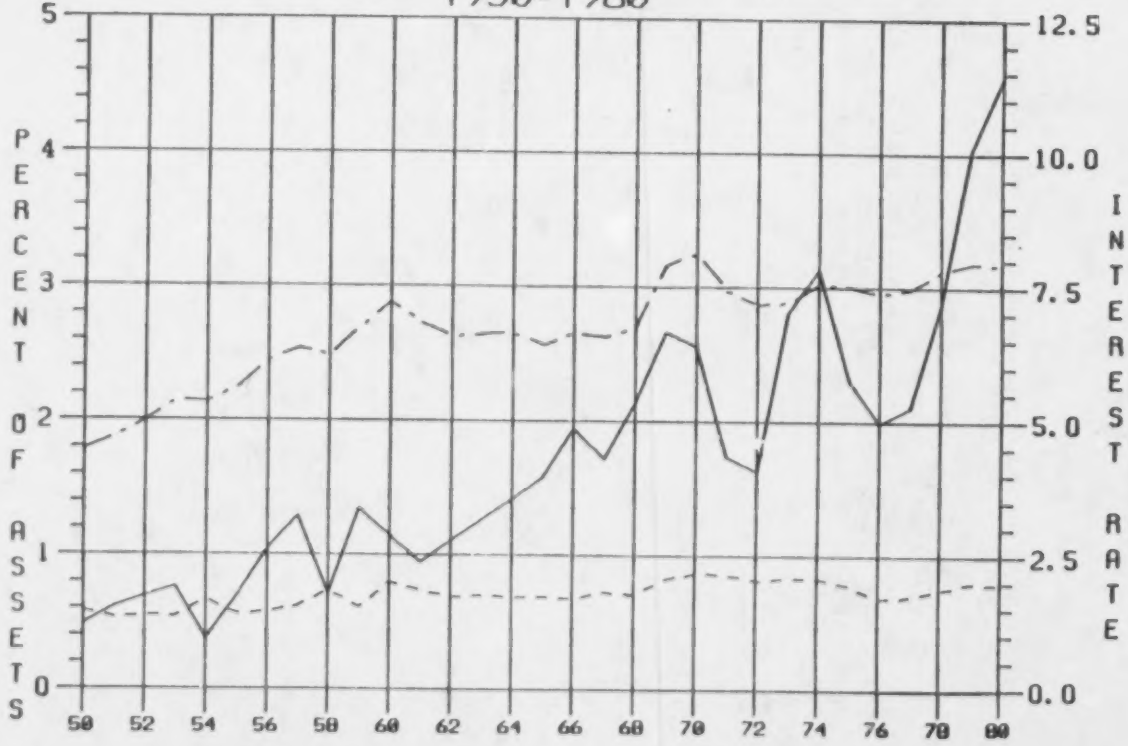
[In thousands of dollars]

	All industries [1]	Banking [2]
Net income (less deficit)	219,243,043	4,919,457
Net income	245,274,490	5,590,306
Income subject to tax	212,501,782	4,828,737
Income tax, total	96,340,453	2,153,992
Additional tax for tax preferences	263,316	8,452
Foreign tax credit	(26,006,028)	(586,838)
U.S. possessions tax credit	(837,687)	
Investment credit	(11,038,404)	(259,820)
Work incentive credit	(19,327)	(179)
New job credit	(1,703,838)	(49,623)
Income tax plus preference tax less credits	56,998,485	1,265,984

[1] IRS publication 16 (12-81) p. 27.
[2] IRS publication 16 (12-81) p. 33.

Chart 1

INTEREST RATES AND COMMERCIAL BANK PROFITABILITY 1950-1980



NET INTEREST INCOME AS A PERCENT OF AVERAGE ASSETS — — —

NET AFTER TAX INCOME AS A PERCENT OF AVERAGE ASSETS - - - - -

AVERAGE RATE ON 3-MONTH TREASURY BILLS. ————————

SOURCE: FDIC, FEDERAL RESERVE

TABLE 2.—*Net income as a percent of average assets—rank of bank profitability compared to 30 other industries* [1]

Year	Rank	Year	Rank
1969	21	1975	9
1970	23	1976	17
1971	17	1977	23
1972	8	1978	23
1973	8	1979	23
1974	9	1980 [2]	40

[1] From survey of industry conducted yearly by Forbes magazine.
[2] 49 industries surveyed.

Chairman ROSTENKOWSKI. Thank you, Mr. Bruning.
Mr. Cohen, you may proceed.

STATEMENT OF EDWIN S. COHEN, TAX COUNSEL, INVESTMENT COMPANY INSTITUTE

Mr. COHEN. Thank you, Mr. Chairman.

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling in Washington, D.C., and I am here before the committee today on behalf of the Investment Company Institute.

The institute is the national association of the mutual fund industry. Its membership consists of more than 600 open end investment companies, generally known as mutual funds, their investment advisers and principal underwriters. The institute's mutual fund members have assets of more than $225 billion and have approximately 18 million shareholder accounts.

The institute is opposed to the Treasury's proposal for withholding 5 percent income tax on dividends and interest. Some 20 years ago, then chief of staff of the Joint Committee on Taxation, Colin Stam, brought together a number of groups to consider the most feasible means of withholding tax on dividends and interest, and I was asked by the institute to make the study on behalf of the mutual fund industry.

After some time, we reluctantly came to the conclusion that withholding on dividends and interest was not feasible, and we recommended instead some other measures, including the use of taxpayer identification numbers and information reports that were adopted. Again in 1980 we gave more serious attention to the subject when it was again considered in the Congress, and once again we came to the conclusion it was not feasible.

The current proposal is similar to the 1980 one except the rate of tax to be withheld has been reduced from 15 percent to 5 percent. The prior proposals had been beset by problems of excessive withholding from charities, pension trusts, universities, the elderly, and children. Lowering the withholding rate to 5 percent reduces these problems but does not eliminate them.

A lower withholding rate, of course, would produce far less revenue. Since the 5-percent tax withheld is less than half of the minimum tax rate, the IRS would still have to pursue other remedies to collect the proper tax. To reduce overwithholding the proposal would also permit nontaxable recipients to file exemption certificates with each of their payors.

We believe that the cost and burden of administering the proposed 5-percent withholding system with its multitude of withholding exemption certificates would be so heavy that it would come close to or even exceed the estimated revenue yield.

Now there are some 18 million shareholder accounts in the mutual fund industry, and of these we estimate that some 7 million, or approximately 40 percent would be entitled to file exemption certificates to eliminate withholding. All of these 7 million withholding exemption certificates would have to be processed by the mutual fund payors and constantly kept up to date in order to eliminate withholding from those payees while withholding 5 percent from all others. Mistakes would be inevitable, adding to the expense.

The best estimates, Mr. Chairman, that we have been able to produce have been that the costs of this proposed system would be in the range of $1.50 or $2 annually for the mutual fund payors. Estimates from some other financial institutions that have testified indicate they would exceed $3.50.

We estimate there would be some 400 million investment accounts of all payees, and if you take the lower range of costs of $1.50 to $2 per account, the total cost of administering the system would be between $600 million and $800 million. If the estimate were in excess of $3 per account, which is less than some of the estimates, the total cost would exceed the additional revenue yield of $1.1 billion that the Treasury estimates, excluding difference in timing of receipts.

We reluctantly come to the conclusion that the cost and burden of this proposal is too high in relation to the revenue gain. Wage withholding by contrast raised on the order of $224 billion in 1980, a vastly higher sum.

On the other hand, while we have not had time to explore this fully, we are inclined to believe that the proposal in H.R. 5829, introduced by Congressman Conable, is a far more promising approach. That bill would require withholding of 15 percent tax on all accounts that do not provide taxpayer identification numbers or that the Commissioner notifies the payors bear incorrect numbers. Our test checks indicate that only between 3 and 4 percent of shareholders accounts in mutual funds lack taxpayer identification numbers. Thus, this bill, H.R. 5829, would seem to involve far less expense and administrative burden than the Treasury proposal while withholding at three times the rate.

We believe it is likely to prove far more feasible than across-the-board withholding of 5 percent, with the multitude of exemption certificates that would be involved.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF EDWIN S. COHEN ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

My name is Edwin S. Cohen. I am a member of the law firm of Covington & Burling, Washington, D.C., and I am of counsel to the Investment Company Institute, on whose behalf I appear today.

The Institute is the national association of the mutual fund industry. Its membership includes more than 600 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund mem-

bers have assets of more than $225 billion, and have approximately 18 million shareholder accounts.

Mutual funds are designed to permit thousands of investors to pool their resources as shareholders in a fund which in turn invests in a large number of stocks or debt instruments under the supervision of a professional investment adviser. Mutual funds provide an economical way by which investors can obtain professional advice and diversification of investments. The shareholders of the fund are the owners and are entitled to all of the fund's net income, which consists of the dividends, interest and net capital gains generated by the fund's investment, less the fund's operating expenses, such as investment advisory, custodial and accounting fees.

The mutual fund industry has always been most anxious to assist in the improvement of the operation of the internal revenue system. In particular, some twenty years ago, when a proposal for withholding of tax on dividends and interest was under consideration in the Congress, the Investment Company Institute spent considerable time studying various methods of withholding to determine the method that was most feasible. In the course of this work, we came to the conclusion that the proposal then made, even after it had been substantially revised, was not feasible and that it would impose an unreasonable burden, especially upon lower middle and middle income shareholders of the funds. The Institute did recommend a number of measures to improve compliance, including the institution of greatly expanded reporting by payors on Form 1099, and its members have endeavored to cooperate with the I.R.S. in its administration of the program.

Again in 1980, when a similar withholding proposal was made to the Congress, we gave the most serious attention to its feasibility and once again came to the conclusion that it should not be enacted, but that other measures and remedies were preferable. Reluctantly, we come to the same conclusion with respect to the Administration's present proposal, which is similar to the 1980 plan except that it would withhold from dividends and interest 5 percent instead of 15 percent.

However, although we have not yet had the opportunity to explore it fully since its introduction a few days ago, the Institute believes that the provisions of H.R. 5829 (and the companion bill S. 2198) for withholding 15 percent tax when taxpayer identification numbers are not furnished by payees is likely to prove more feasible and to be more efficient, with substantially less expense and paperwork.

INHERENT DILEMMAS IN PROPOSALS FOR WITHHOLDING TAX ON INTEREST AND DIVIDENDS

Withholding tax on dividends and interest involves an inherent difficulty that is not found in withholding on wages and salaries. In wage and salary withholding the amount of income tax to be withheld by the employer varies with the marital status of the employee, with the number of personal exemptions of the employee and with certain other factors related to his own personal situation. The amount of tax withheld is graduated on a rate schedule designed to approximate the tax that will actually be due on the employee's final return. This is feasible with respect to wages and salaries because most individuals work for only one employer, from which they receive frequent payments of compensation, and have a direct personal contact with the employer on the business premises where they work. When the employee's marital status changes he or she notifies the employer readily by personal contact, and the percentage of tax withheld varies automatically according to withholding tables as the employee's periodic compensation increases or decreases. Thus withholding on wages and salaries is tailored in general to the final tax liability of the employee.

This system of withholding is not feasible with respect to dividends and interest for a number of reasons. Persons who receive dividends and interest frequently derive the income from a variety of different sources. Their contact with the payors often exists only through the mails, and they often must deal with a distant computer. Their stocks and bonds are frequently registered in the names of banks, brokers or other agents, and they frequently shift investments. There is no feasible way to correlate the amount of tax to be withheld with the amount of tax that the payees will ultimately owe. Thus every withholding system for interest and dividends that has ever been considered has involved a flat rate of withholding, although the ultimate tax owed by the payee is based on a graduated tax schedule after allowance for various deductions.

But withholding a flat rate of tax on dividends and interest involves a dilemma in choosing between (1) administrative feasibility and simplicity for payors, payees and the I.R.S., and (2) fairness to those payees who owe no tax or owe substantially less than the amount withheld. Elemental fairness requires some means for exempting

from withholding payments made to charities, universities and other exempt organizations, the elderly, children, pension trusts and others who owe little or no tax. Moreover, there is no point in having persons withhold tax on payments made to banks, mutual funds, insurance companies, corporations, brokers and the like, who as payees are better equipped to pay the proper tax than are many of the payors to withhold the tax and pay it over to the I.R.S.

Thus in designing a system of dividend and interest withholding, one is forced to the conclusion that many payees should be permitted to file exemption certificates with payors, so that payors will either (1) withhold a flat percentage of the dividend and interest payment or (2) withhold nothing. In that event some written statement must be given by the payor to each payee to attach to his or her tax return to show whether or not tax was withheld on the payment. The procedures for handling of exemption certificates, in the myriads of cases in which they would be permitted, involve enormous administrative problems and expense and inevitable errors, particularly since so many exemption certificates will move by mail without the personal contact between payor and payee that exists with respect to wages and salaries.

A second dilemma exists in fixing the flat rate of withholding. If the rate is high, there will be extensive overwithholding, forcing payees to wait until they have filed their tax returns after the close of the year and have obtained a refund from I.R.S. If the rate is low, it will capture little of the tax actually due from payees, and the expense and difficulties of administering the withholding system will be large in relation to the I.R.S. receipts from the withholding.

In 1961 and 1962 the Treasury proposed withholding of 20 percent, and in 1980 it proposed 15 percent. Both of those proposals were shown to involve extensive overwithholding. In an attempt to reduce the amount of overwithholding, the Treasury now proposes a low withholding rate of 5 percent. The lower rate would reduce, but would not eliminate, the overwithholding. Naturally it is estimated to produce less revenue, but the cost and paperwork, both for payors and payees, of instituting and operating the system would be the same and would be much higher in relation to any revenue gain.

Under a withholding system involving only a 5 percent rate, the I.R.S. would naturally have to pursue, as it now must do, all those who owe tax of more than 5 percent. In 1983 the individual income tax rates will run from a bottom rate of 11 percent to a top rate of 50 percent. Thus for any payee receiving dividends and interest who is otherwise subject to tax, the 5 percent withholding on dividends and interest would be less than half of the lowest tax rate and only one-tenth of the top bracket rate. Withholding at 5 percent would be an inadequate tool to deal with intentional or unintentional omission of dividend and interest income from an income tax return. Obviously the I.R.S. would have to pursue other remedies, and if additional statutory authority is needed by the I.R.S., 5 percent withholding will not suffice.

OVERWITHHOLDING

Lowering the withholding rate to 5 percent, as now proposed, will, as noted above, reduce the number of cases in which excessive amounts will be withheld by payors but will not eliminate the problem. The lower withholding rate, together with permission for persons over 65 to claim exemption from withholding if their tax liability for the previous and current year is below $500 ($1,000 on a joint return), would substantially eliminate overwithholding for those over 65. But for persons under 65 whose income is derived from dividends and interest, overwithholding would occur in a significant number of cases because those persons could not claim exemption from withholding if they have any federal income tax liability whatsoever in the previous or current year. For example—

A married couple, retired at age 63, with interest and dividend income of $5,601 in 1983, who have no other income except from social security and who do not itemize deductions, would–

Have tax withheld of	$280.05
But would owe federal income tax of only	.11
Resulting in excess withholding of	$279.94

The excess withholding of $279.94 would not be returned to them by I.R.S. until after they file their 1983 tax return in 1984, and the refund would bear no interest.

Similar overwithholding would occur with respect to single persons under age 65. In general, overwithholding would occur for married couples under 65 in such situa-

tions if their income from dividends and interest ranged between $5,601[1] and $9,624, and for single persons under 65 between $3,401 [1] and $5,739. The extent of the overwithholding in years beyond 1983 would depend upon the income tax rates then in effect and would increase when the exclusion of up to $450 per person from interest income under section 128 of the Code becomes effective in 1985.

ADMINISTRATIVE BURDEN

The Institute estimates that there would be approximately 400 million different dividend and interest bearing investments held by investors that would require withholding or processing of exemption certificates under the Treasury's proposals.[2] The proposal would represent a significant paperwork increase over present law. Not only would there be an increase of twenty-five percent in the number of dividend and interest bearing investments subject to reporting on Form 1099, but, unlike present law, taxpayers would be required to attach the Forms 1099 to their tax returns.

The process of withholding from some payees yet not from others, and the preparation and distribution of Forms 1099, would entail a heavy and costly administrative burden. Individuals would not be able to claim credit for the tax withheld unless they attached all required Forms 1099 to their returns. Thus, it would be necessary for payors to supply replacement copies for Forms 1099 that are lost during mailing or otherwise. Clerical errors would be inevitable. Replacement and correction of Forms 1099 would require costly individual correspondence and handling.

The administrative burden of the proposal would be intensified by the need to process exemption certificates. The number of investors who would be entitled to file exemption certificates would be large indeed, including the following:

(1) All individuals under age 65 who had no tax to pay in the prior year and expect to pay none in the current year.

(2) All married individuals over 65 owing less than $1,000 tax in the prior year and expecting to pay less than $1,000 tax in the current year, and single persons over 65 owing less than $500 tax.

(3) All tax-exempt organizations, including charities, colleges, foundations, pension and profit-sharing trusts, individual retirement accounts, etc.

(4) All corporations.

(5) All banks, brokers, securities dealers and certain other nominees who hold investments in their names for the benefit of their customers.

The Institute estimates that approximately 40 percent [3] of the 17.9 million shareholder accounts in mutual funds would be entitled to file exemption certificates. This would mean that in the mutual fund industry alone some 7 million exemption certificates could be filed by payees and have to be processed and administered by the payors. We believe that, especially since most of these exemption certificates would have to be communicated through the mails without personal contact, the administrative burden upon the mutual fund industry and its shareholders would be onerous indeed, not only in instituting the system but also in maintaining it as shareholders enter and leave the mutual funds and their entitlement to exemption changes.

If exemption certificates were not filed and processed by the payors before interest and dividends were paid to these persons, tax would have to be withheld by the

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[1] Below these amounts the individuals would be entitled to claim exemption from withholding because the combination of personal exemptions, the $100 per person dividend exclusion and the zero bracket amount would leave no tax due. If the income were entirely from interest, the amounts would be somewhat lower. If deductions were itemized, the upper limits for overwithholding would be higher.

[2] This is more than four times the number of employees subject to wage and salary withholding, and more than two and a half times the number of Forms W-2 filed with I.R.S. in 1980 for wage and salary withholding.

[3] Our data indicates that some 3.3 million shareholder accounts in mutual funds are so-called "institutional accounts," owned by pension and profit-sharing plans, charities, corporations, other financial institutions, etc., which would be entitled to exemption from withholding. In addition, with respect to the remaining 14.6 million accounts owned by individuals, surveys indicate 37 percent are over 65 years of age, and the Treasury's General Explanation of its withholding proposal estimates that 70 percent of persons over age 65 would be entitled to claim exemption from withholding. This would indicate that about 3.8 million elderly mutual fund shareholders would be entitled to claim exemptions. The aggregate of the institutional accounts and the exempt elderly accounts would be more than 7 million accounts out of the aggregate of 17.9 million that would be entitled to file exemption certificates, or approximately 40 percent. Moreover, children and others below 65 owing no tax would also be entitled to file exemption certificates.

payor and the exempt payee would have to await a refund after filing a tax return in the following year. A large proportion of the exemption certificates would have to be sent by payees to payors through the mails, and they could be delayed in transmission or misdirected, without the direct personal contact that readily exists between employer and employee in wage and salary withholding. Mistakes of clerical employees would be certain to occur, creating confusion and resentment of exempt payees whose goodwill is vitally important to the payors.

The filing of exemption certificates would be especially important to retired persons who would otherwise be subject to overwithholding and who would have to claim exemptions promptly. And where stocks, bonds and Treasury obligations are bought, sold and transferred in numerous transactions every business day, the filing and prompt processing of exemption certificates near to interest or dividend payment dates would create a severe clerical burden on the financial industry.

The Treasury estimates that dividend and interest withholding would generate 1.1 billion dollars of revenue in fiscal 1984, exclusive of differences in timing. This revenue estimate must be weighed against the administrative costs of the proposal. The Institute has not been able as yet to make a systematic cost estimate of administering the proposed system. However, it has received estimates from several mutual fund payors that withholding would cost in the range of $1.50–$2.00 per account annually. Per account costs may vary for other mutual funds and for other types of financial institutions. However, given that approximately 400 million dividend and interest bearing investments would be covered, an average annual cost of $1.50 to $2.00 per account would result in a total administrative cost of $600 to $800 million to payors. This would seem to be an excessively high ratio of cost to estimated revenue.

We would note that, according to the 1980 Annual Report of the Commissioner of Internal Revenue [4] and the latest I.R.S. Statistics of Income for 1980,[5] income tax withholding on salaries and wages in 1980 involved about 150 million Forms W–2 that produced some $224 billion in withholding. In contrast, the proposed withholding on dividends and interest, which would be more costly and difficult to operate, would involve some 400 million Forms 1099 that would produce about $7.5 billion in withholding, of which only $1.1 is estimated by the Treasury to result in additional revenue.

TIME OF WITHHOLDING

The Institute is also concerned that the Treasury's withholding proposals would provide different rules as to time of withholding by various types of financial institutions paying interest and dividends, and these variations would provide competitive differentials in the investment yield to payees. For example, it is provided that depository institutions, such as banks, would not have to withhold until the last day of the calendar year on interest accruing throughout the year. Other competing financial institutions, such as mutual funds, insurance companies, brokers and dealers, would be required to withhold throughout the year as dividends and interest were paid. Under the highly competitive conditions that exist in the financial markets, a difference in the time of withholding would provide an unwarranted advantage to depository institutions in the yields they could make available to investors. We appreciate the desire in the proposals to minimize the cost of administration of withholding by depository institutions, but there would be a comparable need for competing financial institutions and it would be difficult to coordinate the various rules as to time of withholding.

THE PROPOSAL IN H.R. 5829 FOR WITHHOLDING IN THE ABSENCE OF THE FURNISHING OF TAXPAYER IDENTIFICATION NUMBERS

The Institute believes that the proposal in H.R. 5829 (introduced March 15, 1982 by Congressman Conable) and the companion bill S. 2198 (introduced March 11, 1982 by Senators Dole, Grassley and Chafee) to require 15 percent withholding when payees have not furnished to payors the required taxpayer identification numbers, or when the Commissioner has notified the payor that the number is incorrect, provides a far more promising method of combating underreporting of dividend and interest income than the suggestion for across-the-board withholding of 5 percent from those not filing exemption certificates. While the Institute has not had the opportunity to explore sufficiently with its member companies the provisions of H.R. 5829

[4] Page 30.
[5] SOI Bulletin, Vol. 1, No. 3, p. 14.

in the brief time since it was introduced, it believes H.R. 5829 is likely to be more effective and to involve substantially less administrative expense and burden.

The mutual funds have endeavored diligently to obtain taxpayer account numbers from their stockholders. The Institute's test checks indicate that the proportion of mutual fund shareholder accounts without taxpayer identification numbers is on the order of 3 percent to 4 percent, whereas, as noted earlier, it appears likely that approximately 40 percent of the shareholder accounts would be entitled to file exemption certificates.

It would appear, therefore, that H.R. 5829 would be far less costly, and that a withholding of 15 percent would likely be far more productive of revenue than a withholding of 5 percent. An increase in penalties for non-compliance, along the lines of H.R. 5829, would also seem to have a salutary affect.

We shall endeavor promptly to consult with the member companies about practical suggestions for operation of the 15 percent withholding proposal in H.R. 5829, but we are inclined to believe that it is more feasible than, and far preferable to, across-the-board 5 percent withholding with a vast number of exemption certificates.

Chairman ROSTENKOWSKI. Thank you, Mr. Cohen.

Miss Sullivan, you may proceed.

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.

Ms. SULLIVAN. Thank you, Mr. Chairman. I am Margaret Cox Sullivan. I am president of Stockholders of America, and I thank you for this opportunity to appear again before this committee.

We are grateful that these hearings have been scheduled and we will limit our remarks to the proposal to withhold 5 percent of the dividend payments from the stockholder for the Internal Revenue Service because we believe the facts concerning dividends and interest are not analogous. It would seemingly appear as a very narrow issue, but it could bring about far and wide repercussions, particularly at this time.

We are all aware of our Nation's debt and deficit and the need to search out ways to cut spending and to find added revenue, but this particular proposal would not solve these problems. In fact, it would be a disincentive and discouragement to risk-taking investment. Investment is imperative to economic growth. We opposed this withholding on dividends on this basis in the past and we have some pretty good evidence to say we were right.

More and more Americans are becoming stockholders. Incentives are the key. A survey just released in December revealed that during the 12-month period from June 1980 to June 1981 the number of stockholders who own stock directly increased by 7 percent.

Over 2 million more people became capitalists and took an active part in our free enterprise system or peoples' capitalism. Over 200,000 new stockholders a month put their capital to work. There are now 32.6 million stockholders, the largest number ever, and that is good news. It is a real bright spot and a definite trend, and should be nutured not restricted.

The most important fact about this survey is its link to the reduction in taxes on capital gains from 48 percent to 28. After the reduction, new capital raised through public stock offerings was $2.5 billion more for 1978 and 1979 than for 1976 and 1977.

This increase in new capital increased Treasury revenue by $1.8 billion for 1979 and had the potential for creating 160,000 new jobs.

The last survey conducted from June 1980 to 1981 shows an even greater increase in new capital, an increase of $4.3 billion.

This increased revenue from capital gains by an estimated $2 billion from 1981 and had the potential of creating 250,000 new jobs. In other words, capital left working in the market can generate approximately 50 percent of its dollar value in increased revenue. Capital taken out of circulation by withholding generates zero increase in the revenue base.

It must not be overlooked that these surveys do not even take into account the further reduction of tax on capital gains to 20 percent as covered in the Economic Recovery Act. Certainly this should prove an even more attractive tax.

Our system plays a basic role in our economy, but it will not work without capital. Our system depends on continuous supply of new private capital, and to withhold 5 percent on dividends is to withhold capital which should remain productive.

For a country that depends on a capitalistic system it is an enigma why we continue to mistreat capital. We still have a heavy tax on capital gains. We have double taxation on dividends and now this proposal to withhold 5 percent on dividends. This is indicative of a misconception of the vital function of capital in a free enterprise system and diminishes our productivity base.

We are all aware that the main reason for this proposal is based on the belief that a small percentage of income received from dividends goes unreported and untaxed. There are some tax cheaters and we are not here to defend them. But the vast majority of America's 32.6 million stockholders are honest taxpayers and should not be kept from the full use of their capital to catch the small minority.

All corporations that pay dividends are now required by law to report annually to the IRS the amount of dividends paid, the name, the address and, most importantly, the social security numbers of all recipients. Therefore, the IRS already has the information needed to match by computers dividends received against tax returns filed.

The answer to the problem is already built into the system. What it lacks is enforcement. We feel the solution to the problem lies in increasing the enforcement capacity of the IRS not in punishing all dividend-receiving stockholders to catch the few.

Then there is the overpayment of taxes. The Treasury estimates that three-fourths of all tax returns filed reported overpayment of taxes. This proposal would only aggravate the problem.

So actually what the 5 percent withheld would amount to is an interest-free loan from the stockholders to the Treasury. It gives the Government the right to legally tie up an individual's capital, interest-free, and deprive the individual from being able to invest or reinvest that capital.

Capital must be kept mobile if it is going to generate revenue. It is an accepted fact that anything that helps or hinders the mobility of capital helps or hinders economic growth. Certainly, to tie up capital under this proposal would do exactly that—hinder economic growth—and that is not in the best interest of economic recovery. And, of course, economic recovery is what we all want, isn't it?

Thank you.

[The prepared statement follows:]

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.

Mr. Chairman and members of the committee, I appreciate the opportunity to appear again before this distinguished Committee on behalf of Stockholders of America, Inc. My name is Margaret Cox Sullivan and I am President of this ten-year-old national, non-profit, non-partisan, membership organization dedicated to representing the interest of stockholders in all publicly held American corporations.

We are grateful the Committee has scheduled these hearings on the tax proposals in the Administration's Budget. We will limit our remarks to the proposal to withhold 5 percent of the dividend payments from the stockholder for the Internal Revenue Service only, because we believe the facts concerning dividends and interest are not analogous. It would seemingly appear as a narrow issue, but it could bring about far and wide repercussions—particularly at this time.

We are all aware of our nation's debt and deficit and the need to search out ways to cut spending and find added revenue but in our opinion this particular proposal would not solve these problems. In fact it could be counter-productive because it would be a disincentive and discouragement to risk taking investment. Investment is imperative to economic growth. We opposed this withholding on dividends on this basis in the past and we have some pretty good evidence to say we were right.

More and more Americans are becoming stockholders. Incentives are the key. A survey just released in December (N.Y. Stock Exchange) revealed that during the 12-month period from June 1980 to June 1981, the number of stockholders who own stock directly, increased by 7 percent. Over 2 million more people became capitalists and took an active part in our free-enterprise system or people's capitalism. Over 200,000 new stockholders a month put their capital to work. There are now 32.6 million stockholders—the largest number ever—and that's good news. It is a real bright spot and a definite trend.

One of the most important facts about this survey is its link to the reduction in taxes on capital gains which is conceded to be the incentive that attracted this new risk capital—proving incentives are the key. The survey was conducted after the 1978 Revenue Act went into effect which reduced the tax on capital gains from 48 percent to 28 percent. Let me give two examples of how the increase in the number of stockholders relates to increased revenue and generates new jobs.

After the capital gains tax became effective on January 1, 1979, 132,000 new investors entered the stock market in an average month compared to the previous average month figure of 87,000. New capital raised through initial public stock offerings was $2.5 billion more for 1978–79 than for 1976–77. This amount of money has the potential to create 160,000 new jobs. Treasury revenue from capital gains increased by $1.8 billion for 1979. In the survey just released for the 12-month period June 1980 to June 1981—which brought in an additional 2 million new stockholders—capital raised through initial public stock offerings was $4.3 billion more in 1981 than in 1980. This amount of money has the potential to create more than 250,000 new jobs. Treasury revenue from capital gains increased an estimated $2 billion for 1981.

In other words, when capital is left to work in the market it generates approximately 50 percent of its dollar value in increased revenue to the Treasury. Taken out of circulation by withholding by the government, it generates zero increase in the revenue base.

It must not be overlooked that the further reduction to 20 percent on transactions after June 9, 1981, as covered in the 1981 Economic Recovery Act which this Committee passed, was not included in the survey. Certainly then this further lowering of the tax on capital gains will prove to be an even greater incentive for stock investment—given a chance.

It is a clear illustration—as we at Stockholders of America have vehemently contended—that given equitable and fair tax incentives—and not penalties—the American people will provide the productive capital to get our once great American business machine going full-speed again.

This trend must be nurtured. Our capitalistic system plays a basic role in our national well-being and our national economy. It is unique in that. But it won't work without capital. Our system depends on a continuous supply of new private capital and to withhold taxes on dividends is to withhold capital which should remain productive. And historically, this working capital comes from millions of individual investors called "the little guys" whose average portfolio—according to this survey—is $5,450.

For a country which depends on the capitalistic system it is an enigma why we continue to persist in mistreating capital. We still have a heavy tax on capital gains, we have double taxation on dividends and now this proposal to withhold 5 percent on dividends for the Internal Revenue Service. This is indicative of a misconception of the vital function of capital in a free-enterprise system and diminishes our national productivity base. No wonder we have such a low rate of investment as compared to other industrial countries.

We are all aware that the main reason for this proposal to withhold 5 percent on dividends is based on the belief that a percentage—a small percentage—of income received from dividends goes unreported and untaxed. I don't know how we're going to legislate honesty. There probably will always be some cheaters and we're not here to defend them. The law is already in place to prosecute these offenders by fine or a jail sentence or both.

But the vast majority of America's 32.6 million stockholders are honest taxpayers and should not be kept from the full use of their capital to catch the small minority who are trying to avoid their responsibility.

All corporations that pay dividends are now required by law to report annually to the IRS the amount of dividends paid, the name, address—and most importantly—the social security numbers of everyone who receives them (Internal Revenue Code, Sec. 6109). In the case of stock held in street name, the brokerage firm must report; in case the stock is in trust, the bank reports.

Therefore, the IRS now has the information to match by computer the amounts of dividends reported by paying agents against tax returns filed. The answer to the problem then, is already built into the system, what it lacks is enforcement. It is our understanding that the IRS is understaffed to do the job properly. We feel that the solution lies in increasing the enforcement capacity of the IRS not in punishing all dividend receiving stockholders to catch the few.

So actually the 5 percent withheld, is an interest-free loan from the stockholders to the Treasury and gives the government the right to legally tie-up an individual's capital, interest-free, and deprive the individual from being able to invest or reinvest that capital.

Further, the Treasury estimates that three-fourths of all tax returns filed, reported overpayment of taxes. Overpayments are expected to soar this year as a result of scheduled tax cuts and indeed the Treasury has expressed concern and this proposal would aggravate the problem.

Capital must be kept mobile if it is going to generate revenue. It is an accepted fact that anything that helps or hinders the mobility of capital, helps or hinders economic growth.

Certainly, to tie-up capital under this proposal would do exactly that—hinder economic growth—and that's not in the best interest of our economic recovery. And economic recovery is what we all want, isn't it?

Again, thank you.

Mr. CONABLE. Thank you very much. This is a terrible way to run the store and I am sorry about it. We cannot really stop casual acts of statesmanship while we are on the floor as they call for really unwarranted votes. That is democracy. Nobody ever said it would be efficient.

Eddie, I missed your testimony, but I am wondering, did you take a position on this proposal for cranking the 1099's into the computers, and if so, what was your position?

Mr. COHEN. Mr. Conable, we supported the bill you had introduced on March 15, H.R. 5829, at least to indicate that while we had not had the opportunity to check it with the entire mutual fund industry we think it is a far more promising approach than across-the-board withholding of 5 percent.

As I understand your proposal, you would require withholding of 15 percent from those payees who do not furnish their taxpayer identification numbers or the Treasury finds have incorrect numbers. We find that that would involve in the neighborhood of 3 to 4 percent of the 18 million shareholder accounts and would be likely to be a manageable matter, whereas under the Treasury proposal 40 percent of the shareholder accounts would be entitled to file ex-

emption certificates, and we think that cost would be excessive in relation to the estimated revenue yield.

Mr. CONABLE. The enforcement proposals go beyond the penalty you suggest, the 15 percent withholding for those who have failed to file taxpayer numbers and so forth. For instance, it involves also taking the steps necessary to have some computer check of the 1099 forms that are sent out by corporations. These forms are now just papers blowing in the wind, as far as the Government is concerned, despite the fact that they do serve as a notification to the stockholder of his obligation to pay tax on dividends.

I am wondering, in fact, if you have taken a position on that. There is also a provision which permits voluntary withholding of payouts with IRA's. With IRA's and Keoghs you are going to be receiving taxable income. The provision does not mandate it, but if the taxpayer elects, he can request the banks or the other financial institution holding the IRA fund to withhold on payouts made to him or her, as appropriate at an appropriate withholding rate.

Mr. COHEN. Back in 1969 we instituted that as a voluntary withholding system in connection with pension plans. I think it should be extended to this area as well.

Mr. CONABLE. But you have not taken a position on the 1099's.

Mr. COHEN. Congressman, back in 1962 when I testified here on the same subject we did support the institution of 1099's for dividends and interest in the mutual fund industry and the banks have done so ever since. It is my understanding, Congressman, that the IRS in the last couple of years has done a good job of matching up those 1099's with the tax returns.

But I understand that one of their great difficulties, the principal one is that a lot of the 1099's do not include the taxpayer identification number, the social security account number, and it is very difficult for them to match them up with the tax returns if they do not have the number.

I think that that is why I emphasize that your bill, where you would withhold 15 percent when the stockholder does not send in his taxpayer identification number, is going to get that last 3 or 4 or 5 percent of the accounts to furnish the taxpayer identification numbers.

They will either sell out and put the money in a mattress or they are going to give the identification number, I would think. So I think this provision of your bill would be a great aid to the IRS and increase enforcement. While we have not explored all our mechanical problems, we are inclined to think it is much easier to do, much less expensive, and much more cost-effective than across-the-board withholding of 5 percent accompanied by a flood of what we calculate will be on the order of 100 to 150 million exemption certificates that would have to be processed.

Mr. CONABLE. Miss Sullivan, do you generally agree with the statement Mr. Cohen has made?

Ms. SULLIVAN. Yes, I do. Yes, I do.

Mr. CONABLE. That is all, Mr. Chairman.

Mr. STARK [presiding]. I want to thank the panel. I take this opportunity to ask the diverse interests here to see whether Mr. Cohen's industry would have any objection to Mr. Bruning's industry joining forces and perhaps selling money market funds through

banks and other financial institutions with the idea that deregulation ought to be spread around to all industries.

Are the investment companies going to oppose banks being allowed to get more active in the securities business?

Mr. COHEN. Mr. Stark, I frankly do not recall the full position of the Institute, as it has testified before the Banking Committee. I know that in my work for the Institute it has always taken the position that everyone should be able to compete on equal terms.

I think they have distinct reservations, though, about the ability of the banks to be both lenders and investors. My inclination is that they have opposed the concept of the banks being involved in the securities business. This goes back to 1933.

I do not think they have any opposition to the removal of the Regulation Q requirements on the banks that have led to the origin of the money market mutual funds, but I think they are opposed to the banks being both the providers of credit for businesses and investors in the common stock equity of those businesses.

Mr. STARK. I am thinking even more of the money market funds which are so much a part, really, of your industry now, not just the equity funds but the money market funds, because as I see it, and I would be curious about Mr. Bruning's reaction, Sears, Roebuck and American Express are in it for better or for worse, and Chase and Bank of America will be in it soon.

Now a bank of Mr. Bruning's may not have that option. They might very well find a way to sell the product of your client to their customers in exchange for your client keeping some of their deposits in his bank. I think that is the kind of thing that has been suggested and it seems to me to create no problem.

I guess I would ask Mr. Bruning. I think it is the medium-sized banks really that need the product of the investment companies to be able to compete with the major banks and the major retailers who are coming out with them.

Do you have any feeling on that? I am not asking about the American Bankers' position but as the president of a medium-sized bank or a large independent bank.

Mr. BRUNING. A community bank. I just might point out that there are about 13,000 banks which have assets of $100 million or less. That is a substantial majority of banks. It is not a big bank-small bank issue. It is an issue of a strong central banking system. Money is being drained out of local communities into major financial centers.

As you know—and I am not going to debate the issue of deregulation—the ABA has supported deregulation. We have supported the removal of Regulation Q and a long-term phaseout of interest rate regulation. We have also asked for a competitive deposit instrument that would allow us to compete with money market funds.

Speaking personally as well as for the members of my council, we need and we are in favor of some form of deposit instrument which would give us the ability to compete with mutual fund money market activities.

Mr. STARK. Just one other question of the panel. I think that most people would agree—I want to quote from Fortune, from something somebody just presented me—that in March they said

that businesses' dismal record of putting its parochial interests above the general good is the darkest cloud over Washington's new approach to taxes.

I do not direct that at the present panel, but I am concerned with this. I guess I believe and I think a lot of people who are in town today—the realtors who are in town; the homebuilders are in town; the autoworkers cannot afford to get here—are concerned about high interest rates. I do not see how we can be addressing interest subsidies or tax credits to one segment or another and not just be intensifying the demand for credit.

Nobody wants to go along. I will finish my statement and then ask for your comment. My feeling is no long-term investment money because of uncertainty. The rates are high enough to attract long-term money, but nobody knows if you go along at 17 if it is going to be 25.

I think if we could have some sense in the investment community that there was a 5-year stable field, as Eddie mentioned, this forces all the maturities, Federal, corporate, municipal, into the shortterm market along with the second deeds and wraparounds that are coming through.

Can you make a case for increased tax credits or more tax expenditures now when interest rates—to me that only exacerbates the interest rate problem. While it may help if we give it to the homebuilders, it may help them in a very short-term nature but it is not going to create any long-term lending.

The auto industry will then want the same thing. How do you limit this just to say we will give you a tax credit to buy a house, but not give you a tax credit to buy an automobile. You have two depressed industries.

I tend to want to back away from that and say we have to deal with the aggregate, getting things stable and getting long-term money back before we can begin to help an individual industry.

Miss Sullivan.

Ms. SULLIVAN. I agree with you—two great minds.

Mr. STARK. Thank you.

Mr. BRUNING. I am certainly not a tax expert; I will ask Paul to respond to that. But I think the turmoil in the market and the fluctuations in interest rates are reflections of the lack of confidence investment decisionmakers have in the future.

Personally I believe that the market, given the right amount of leadership and the right direction in terms of some future economic recovery process, will correct itself. It should in the free enterprise system.

Paul.

Mr. CLAYTOR. I have nothing further to add to that. I think our prepared statement on the tax proposals before the committee right now speaks for itself.

Mr. COHEN. Congressman, speaking as a citizen and not on behalf of the Investment Institute, I have never been in favor of this proliferation of the credit that we have had over the last 20 years. We seem to have them one after the other. I think that they shift investments from one sector to another but I do not think that they stimulate the economy as a whole.

I might say as an amateur economist I can understand why the budget deficit forces up long-term interest rates, but I have not found an explanation why 90-day interest rates are still in the range of 14 and 15 percent.

Mr. STARK. Because nobody wants to——

Mr. COHEN. Assuming they are not going long and, as you say, the lending funds are shifting into short term instead of long-term, that would seem to me to give a greater supply of short-term funds than customary and drive down the short-term rates.

I do not see why the ultimate deficit is holding up short-term rates. I am reminded that in the spring of 1980, and I have had to look into this, in the second quarter of 1980, short-term Treasury bills fell from almost 14 percent to 7-and-a-fraction percent in a period of 6 weeks, and it could happen again.

Mr. STARK. It could, but as I sense what is happening in all of the bond offerings, we are having to get into such things as zero coupon bonds, which can really come back and bite you in the back of the neck, as it were, if interest rates turn around. These could be dangerous instruments.

But as the corporate stuff comes due, as some of this fancy real estate financing provisions holding tremendous construction loans on tracts and condominiums, the Federal Government's debt rolls over just like a mill grinding and they cannot go long and get the rates.

So you are getting all of this normally revolving debt getting force into the short-term market and that is where Mr. Bruning competes with his CD's. They are talking about 30-year amortization, but they are making 3- and 5-year loans. That is not long.

So if a guy is buying a home he is buying a home with a 2-year loan. He has a right to extend it but the rates are pretty open ended out there and you are concentrating the entire credit mechanism of this country in way under 5 year, and I bet the average debt renewing today is in the 2 year.

That is just the opposite of where it has been. That is my feeling on why the short-term rates bobble around, because they are more sensitive to seasonal fluctuations. But until people are content to own debt—that means they have to be content to make a decision as to what the long-term inflation rate is going to be; it is going to be fairly constant and the price of money will be fairly constant—there is no reason to go long, which they taught bankers in banker I-A.

I am sure Mr. Guarini has some questions.

Mr. GUARINI. Mrs. Sullivan, in regard to withholding on dividends, I understand according to a report by the IRS 85 percent of the dividends are actually reported to the Government. That is not too bad a record compared to a lot of other tax neglect and tax cheating, tax inadvertence—whatever you want to call it.

Ms. SULLIVAN. Yes; that's right.

Mr. GUARINI. What really concerns me is the capital gains of which 44 percent, according to the Internal Revenue Service, is reported to the Government. Now there are billions of dollars there that are dropped because of our reporting system.

What recommendation can you have for our Nation in that regard?

Ms. SULLIVAN. This is a difficult question of how you get people to report capital gains correctly.

Mr. GUARINI. Would you speak into the microphone, please?

Ms. SULLIVAN. You could buy a stock from one broker. You could inherit a stock. Then you sell it in another place, so that it is really honesty at that point.

Mr. GUARINI. Honesty is a wonderful thing.

Ms. SULLIVAN. You cannot legislate that.

Mr. GUARINI. If we did not have W-2 forms or 1099 forms, I am sure if we left it to everybody to report their income, there would be a big gap in the tax receivables of our country.

Ms. SULLIVAN. I agree.

Mr. GUARINI. Do you not think it is time the stockholders of America took a position as to how capital gains should be reported so we can have tax equity?

Ms. SULLIVAN. Yes; but I cannot really tell you how it could be done administratively.

Mr. GUARINI. We live in a land of computers and we can actually electronically figure almost everything out. I do not know why it would be so difficut to figure out a reporting system on capital gains. I think your organization ought to take a stand on this.

Ms. SULLIVAN. Well, we will be up here taking a stand on it.

Mr. GUARINI. Good, that is what I wanted to be aware of.

Ms. SULLIVAN. But we have not figured out how it can be done.

Mr. GUARINI. Well, as soon as you find out, the Internal Revenue Service would like to know too.

Ms. SULLIVAN. I know. This is very important to us.

Mr. GUARINI. Mr. Cohen, do you want to make a comment on that?

Mr. COHEN. Yes; I just wanted to point out the difficulty involved. One proposal—I think it is in Mr. Conable's bill, H.R. 5829—I think would require reports by brokers of sales of stock. The selling broker might file with the IRS a copy of the customer's account.

Mr. GUARINI. It is so easy if you really want to, is it not, Mr. Cohen?

Mr. COHEN. Well, no. The broker would know the gross sales-price. He would not necessarily know the cost unless he was also the buying broker.

Mr. GUARINI. The very fact that he reported it and everybody knew that he reported it would put people on notice that there is an accouting that they have to do and it is going to appear on their income tax regarding a sale or a purchase.

Mr. COHEN. Although I have not studied this matter of brokers reporting sales data, I have spent, off and on, over 20 years in efforts to try to figure out how to handle the reporting of dividends and interest. I might say that 85 percent figure that you give, I think, is low for dividends. I think it is over 90 percent or in the range of 90 percent.

Mr. GUARINI. We have a bell and I just want to ask one other question of Mr. Bruning.

Mr. COHEN. All I wanted to say was that you could have brokers report the gross proceeds of sales. You could require the purchaser of a home to file a statement as to how much he paid, but he would

never know what the seller's gain or loss was on the sale. It would involve a large volume of papers for the IRS to process.

Mr. GUARINI. In this age of ingenuity I am sure that there is a way of keeping certain safeguards.

Mr. COHEN. I think the Congressman's bill requires some of that.

Mr. GUARINI. Mr. Bruning, would you comment on the all-savers certificate that was originally designed to go into housing and, of course, the commercial banks have been included in the program and very little of their moneys, probably 10 percent of their moneys, go into housing? What can the American Bankers Association do, the commercial banks do to help in our housing crisis? They have the funds and the resources and the finances and the answers could be partly in their hands.

Mr. BRUNING. I would like to say, first of all, we were opposed to the all-savers certificate on the grounds that it would not generate significant savings.

Second, commercial banks were the primary provider of home mortgage lending last year. I do not have the statistics before me so I am not prepared to report on how much all-savers revenue we had went into housing.

Mr. GUARINI. You had all the liquidity and all the financing in the country at your disposal. If you only put 10 percent of your disposal in housing you know we are not going to have the amount of housing we need, especially when you recognize that your sister industry, the thrift institutions are about ready to close up.

So there is an extra added responsibility that the ABA had with regard to finding a solution with government, because we are all on this together for our housing problems. I wish they could really come forward to Congress and give us some ideas as to how they could be more responsive.

Mr. BRUNING. In terms of housing, all banks have made a commitment to that. As I said, we were a primary provider of mortgage funds last year. In fact, we are the second largest holder of mortgages in the country.

I might say that while there is mortgage credit available it is a fact that interest rates are so high that consumers are simply refusing to borrow. The credit is there.

Mr. GUARINI. Right, but when we find solutions we look to you, not just government, to help us find them together. There are probably many new creative, imaginative ways of financing that I think the genius of American banking can come forth with, unless there is inertia. There is nothing happening.

Mr. BRUNING. There is some inertia there. However, I might just say that at my bank we are working on a program right now to buy low-yielding mortgages from some savings and loans in the Chicago markets, a program which I am asking the ABA to review. So there is some inertia and some imagination and hopefully in the next 30 or 60 days individual banks will be in a position to come forth and come up with a part of a solution.

Mr. GUARINI. I thank you.

Mr. STARK. Thank you. I want to thank the panel. The committee will recess until 9:30 tomorrow morning.

Ms. SULLIVAN. Thank you very much.

[Whereupon, at 2:30 p.m., the committee adjourned, to reconvene at 9:30 a.m., Wednesday, March 31, 1982.]

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

WEDNESDAY, MARCH 31, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 9:35 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. The committee will come to order.

We are always pleased to have our colleagues testify before our committee and give us their viewpoints.

With that, Representative Green, if you will identify yourself for the record and proceed, we are ready to receive your testimony.

STATEMENT OF HON. BILL GREEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. GREEN. I am Congressman Bill Green from New York and, Mr. Chairman, I appreciate the opportunity to testify today before the House Ways and Means Committee on the mass transit leasing provisions of the Economic Recovery Act.

As members of this committee may remember, when Congress was considering tax legislation last year, public transit authorities were asking for legislation that would provide access to lease financing markets for the acquisition of rolling stock and buses.

At the same time it was proposed that transportation equipment leased to public transit agencies qualified for the investment tax credit. These proposals were made to assist public transit companies in their acqusition of equipment and to put them on an equal footing or parity with private transportation entities who have these two mechanisms available to them.

While the investment tax credit was not extended to mass transit vehicles, through my efforts on the Republican side and those of Congressman Rangel on the Democratic side, Congress did ultimately include public mass transit vehicles under the safe harbor leasing provision that was enacted as part of last year's tax bill.

As I will mention later in my testimony, this provision has already meant a great deal both to the New York City subway and bus systems and those of the surrounding area which are integrated into our metropolitan transportation authority, and to others throughout the country.

If safe harbor leasing is repealed without any special position for mass transit, the public systems of our country will lose their half

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a loaf. Frankly, I do not think that is fair. With repeal, private firms will still be covered by conventional lease financing and will retain the investment tax credit.

These provisions of our tax law will not be available to any public transit authority, and the parity that has been established will, after less than 1 year, be ended. I would suggest that this is wrong and that whatever tax benefits are available to private transit operators should be available to public transit operators, indeed even going so far as a negative tax feature where that is necessary to achieve parity.

This approach would make our tax laws neutral as between private and public transit operators, and I think that is only fair. It is important to point out that those of us asking that consideration be given to mass transit are not representing any special interest, in contrast with some who come before this committee to testify on tax matters.

On the contrary, the provision we are discussing today is truly in the public interest. In particular, it is in the interest of the millions of Americans who ride public transit each day and who take the 8.2 billion rides per year that public transit provides.

The benefits these individuals receive are better equipment and better service. The public itself pays for this new equipment. The debt service on new equipment purchased under the safe harbor leasing provision by the New York Metropolitan Transportation Authority is paid for by the riders of our subway and bus systems, and in the case of other systems, by local taxpayers.

No Federal funds can be used in conjunction with safe harbor leasing. Since the adoption of the mass transit provision, many public transportation authorities have begun to integrate this measure into their capital programs and to negotiate contracts for equipment and to enter into a leasing arrangement.

While I am most familiar with the situation in the New York metropolitan area, I understand that local transportation authorities in Philadelphia; Boston; St. Louis; Houston; Louisville; Los Angeles; Cincinnati; San Diego; Oakland, Calif.; Worcester, Mass.; Montgomery County, Md.; and State authorities in Rhode Island and New Jersey are also using leasing.

Many others, I understand, are planning to do so, including Chicago, Atlanta, Portland, Denver, and San Francisco.

Mr. Chairman, I believe that the mass transit leasing provision is an element in the rebuilding of our transit systems. I urge members of this committee not to repeal this measure. A recent General Accounting Office report prepared at the request of the House Appropriations Subcommittee on Transportation, and issued as recently as March 15, established that the mass transit leasing legislation adopted in 1981 is an efficient means of Federal assistance to mass transit.

I urge the members of this committee to give serious consideration to the mass transit leasing provision on the grounds of parity with the private sector and in terms of how this provision serves the public interest. I thank the members for allowing me to testify on behalf of this provision today.

Chairman ROSTENKOWSKI. Thank you very much.

Are there any questions?

[No response.]

Chairman ROSTENKOWSKI. Thank you very much.

Mr. GREEN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Polan, Mr. Seidman, Mr. Penick, Mr. Dickey, Mr. Jaicks, Mr. Tippett, Mr. Borman.

Gentlemen, welcome to the committee. I see many familiar faces. It is always a pleasure to have you here with us to receive the benefit of your views. We look forward to what you have to say.

As is our custom, we will ask each of you to confine your remarks to the time that has been allocated. If your statement runs longer than the time allocated, we will include your statement in the record, and will suggest that you summarize. This will give us an opportunity to engage in a colloquy with each of you.

Will each of you identify yourself for the record as you are called upon, and then proceed to present your testimony?

We will begin with Mr. Polan.

STATEMENT OF STEVE POLAN, SPECIAL COUNSEL FOR LEGISLATION, METROPOLITAN TRANSPORTATION AUTHORITY OF NEW YORK CITY, ON BEHALF OF THE AMERICAN PUBLIC TRANSIT ASSOCIATION, ACCOMPANIED BY PETER STRAUSS, COUNCILMAN, CINCINNATI, OHIO

Mr. POLAN. Thank you and good morning.

My name is Steve Polan from the Metropolitan Transportation Authority of New York. I am here today representing the American Public Transit Association. I appreciate this opportunity you have provided to appear before this committee.

I am submitting a longer statement for the record which I will try to summarize here this morning.

APTA is a national organization representing over 300 local bus and rail transit systems that carry over 94 percent of all transit riders in the United States. The vital role that transit plays in this Nation today in cities large and small is in large part the direct result of the 20-year partnership between the transit industry and all levels of government.

Despite the recent progress that has been made over the past 10 to 15 years and increased State, local, and Federal support for transit, the administration's dramatic cutbacks in direct Federal assistance of almost 30 percent in 2 years means that public transit is again being pushed toward the cycle of fare increases, service cutbacks, ridership decline, and rising deficits that led to the demise of private transit operations in the 1950's and 1960's.

In fact, in testimony before the House Public Works Committee last year, APTA noted that this year alone the transit industry faces an ominous deficit of $1.6 billion between revenues and capital and operating expenses and they projected capital shortfall of over $50 billion over the next decade.

The safe harbor leasing provisions for transit enacted as part of the Economic Recovery Tax Act of 1981 has been the only tangible piece of good news that the transit industry has heard from its Federal partner since the administration began slashing the direct financial assistance program.

Safe harbor leasing for transit is a program that works, is in place today, and on which many public transit systems are relying. It has already been used by at least 14 public transit systems, and many more systems will alter their equipment purchase plans in the future if given the opportunity to obtain lease benefits.

Safe harbor leasing is a small but significant way of making up some of the ground lost to the recent cutbacks in direct Federal assistance, and I should add that on behalf of my own authority, the MTA of New York, safe harbor leasing is a crucial element to our system's urgently needed 5-year capital improvement program that we have put together using local funds to restore our system to a state of good repair.

The funds provided through safe harbor leasing will expand the amount of capital available to transit operators. It will increase the size of our equipment orders. In 1981 the public transit industry sought to obtain the benefit of the investment tax credit for rolling stock to permit lease financing on terms and with benefits similar to those already existing for private transportation.

Because the administration's tax proposals contain more sweeping changes in the tax law related to leasing, the new transit provision enacted by Congress was, through the good efforts of Congressmen Rangel, Green, and Downey, and as a matter of drafting convenience only, grafted onto the new so-called safe harbor leasing proposal.

It is important to note that the justification for transit leasing to reduce the cost of capital and provide indirect Federal assistance to the transit industry was and remains independent of the arguments in favor of or against the other safe harbor leasing provisions.

While the ITC was not made available to transit by the new law, the combination of ACRS and the liberalization of rules relating to lease transactions combined to produce an economic benefit to the transit industry comparable to that originally sought through the ITC.

Repeal of safe harbor in its entirety would return private transportation companies to conventional lease financing as it existed prior to ERTA. Repeal of the provision for transit, however, would eliminate all opportunity for public transit to participate in lease financing, placing transit on less competitive footing with other modes with respect to rolling stock acquisition.

As I indicated earlier, the public transit industry is starved for capital. The distressed state of the industry helps explain why, despite Treasury delays in issuing safe harbor regulations for transit, 14 public transit agencies have already entered into sale and lease-back arrangements.

The aggregate value of equipment transferred to private corporations in these transactions is approximately $212 million. This represents the value of local investment in new buses and subway cars because Treasury regulations do not permit transit agencies to transfer any tax benefits attributable to a Federal grant.

The return to the transit industry varies, depending on whether a bus or a subway car is involved. APTA estimates that the aggregate return to the transit authorities was approximately $35 million. The size of the tax benefit to the private corporations would

depend on its own financial circumstances, but the overwhelming bulk of the benefits was indeed passed through to the transit authorities.

Safe harbor leases for transit have had a relatively insignificant revenue cost to the U.S. Treasury. In fact, the aggregate value for the entire industry is only a small fraction of some of the individual corporate transactions already completed under safe harbor.

Finally, it is important to note that many other transit authorities, including MTA, have reworked their equipment acquisition programs, sometimes at significant public cost, to comply with the safe harbor leasing provisions and are in reliance on its continuation.

For example, MTA of New York, acting in concert with the State of New York, has fashioned a 5-year capital improvement program which assumes the continued availability of safe harbor leasing as a contributor of $500 million in equipment financing. Other systems such as Philadelphia, Chicago, Cleveland, Boston, Atlanta, Miami, and San Diego are now making similar plans.

It has become clear that safe harbor leasing for transit is a program that if continued can benefit large, medium, and small bus systems. The recent announcement that safe harbor leasing provision for transit might be repealed or substantially modified has placed in doubt the hopes of these and other transit systems to improve their bus and rail car acquisition plans through the use of this financing technique.

On behalf of the public transit industry, I urge very much that safe harbor leasing for transit vehicles be retained.

Thank you very much.

[The prepared statements follow:]

STATEMENT OF THE AMERICAN PUBLIC TRANSIT ASSOCIATION

Thank you, and good morning. I am here today representing the American Public Transit Association ("APTA"). I appreciate the opportunity you have provided to appear before this Committee to explain, on behalf of the nation's public transit industry, why we urge the retention of safe harbor leasing insofar as it relates to public mass transit systems and their purchases of "qualified mass commuting vehicles," including buses, subway cars, and commuter rail cars.

APTA is a national organization representing over 300 local bus and rail transit systems that carry over 94 percent of all transit riders in the United States. In addition to public transit systems, APTA members include manufacturers and suppliers of transit equipment and numerous other public and private organizations involved in the planning, design, or construction of transit systems.

Mass transit is an essential public service, with a vital contribution to make to the health and economic well-being of our urbanized areas and the Nation's economic recovery. The vital role of transit today is in large part the direct result of a 20-year partnership between the transit industry and all levels of government.

The federal role in this partnership has been particularly significant since 1964 when Congress adopted the Urban Mass Transportation Act. In fact, direct financial assistance from the federal government for capital and operating expenses of public transit systems helped produce dramatic ridership increases in the 1970's and major improvements in the Nation's urban transportation infrastructure including rolling stock and fixed facilities. Transit provides mobility for all persons including the elderly, poor, disabled, and other transit dependents; relieves congestion; spurs economic development; and improves the quality of life in our urban centers.

Despite the progress that has been made, the Administration's dramatic cutbacks in direct federal assistance of almost 30 percent in two years mean that public transit is again being pushed toward the cycle of fare increases, service cutbacks, ridership decline, and rising deficits that led to the demise of private transit operations in the 1950's and 1960's. In fact, in testimony before the House Public Works Com-

mittee on October 21, 1981, APTA noted that in this year alone the transit industry faces an ominous $1.6 billion shortfall between revenues and capital and operating expenses and a projected capital need of $50.1 billion over the next decade. In a recent survey, more than 25 transit systems indicated that they are facing the very real prospect of closing down operations unless more ways to finance transit can be found, and almost all systems indicated that they are planning a combination of service cutbacks or fare increases. Based on these statistics alone, it is clear that the public transit industry is starved for capital and in dire financial condition.

The safe harbor leasing provision for transit, enacted as part of the Economic Recovery Tax Act of 1981, has been the only tangible piece of good news that the transit industry has heard from its federal partner since the Administration began slashing the direct financial assistance program. There are other proposals, such as Secretary of Transportation Drew Lewis' proposal to increase the gasoline user fee by 5 cents with a penny dedicated for transit, that we welcome and support. That proposal, which has not yet been made an official part of the Administration's program, however, stands independently of the safe harbor leasing provision.

Safe harbor leasing for transit is a program that works, is in place today, and on which many public transit systems are relying. It has already been used by at least 14 public transit systems, and many more systems have altered their equipment purchase plans in order to use it in the future, if given the opportunity. Safe harbor leasing is a small but significant way of making up some of the ground lost to the recent cutbacks in direct federal assistance, and, I should add that for one of APTA's members, the Metropolitan Transportation Authority of New York, safe harbor leasing is a crucial element to that system's urgently needed five-year capital improvement program. The funds provided through safe harbor leasing will expand the amount of capital available to transit operators and will increase the size of their equipment orders.

In 1981, the public transit industry led by the efforts of the MTA of New York, sought to obtain the benefit of the investment tax credit for purchases of rolling stock to permit lease financing on terms and with benefits similar to those already existing for private transportation companies. Because the Administration's tax proposals contained more sweeping changes in the tax law related to leasing, the new transit provision enacted by Congress was, as a matter of drafting convenience, grafted onto the new so-called "safe harbor" leasing proposal.

It is important to note, however, that the justification for transit leasing—to reduce the cost of capital and provide indirect federal assistance to the transit industry—was and remains independent of the arguments in favor of or against the other safe harbor leasing provisions. While the investment tax credit was not made available by the new law, the combination of the new rapid depreciation rules (ACRS) and the liberalization of rules relating to lease transactions combined to produce an economic benefit to the public transit industry comparable to that originally sought through the investment tax credit.

Repeal of the safe harbor leasing provision in its entirety would return private transportation companies to conventional lease financing as it existed prior to the Economic Recovery Tax Act of 1981. Repeal of the provision for transit, however, would eliminate all opportunity for public transit to participate in lease financing, placing transit on less equal footing with the other modes with respect to rolling stock acquisition. Repeal of safe harbor leasing for transit would also negate the independent rationale for including transit in the safe harbor leasing provision in the first place; a rationale that because of the dramatic cutbacks in direct federal assistance stands on even more solid ground than it did previously.

As I indicated earlier, the public transit industry is starved for capital, with a projected need for capital resources over the decade of $50.1 billion, including in excess of $16 billion which is needed for rolling stock alone. The distressed state of the industry helps explain why, despite Treasury Department delays in issuing safe harbor regulations for transit, 14 public transit systems have already entered into sale and leaseback arrangements.

These systems include the MTA of New York; the Massachusetts Bay Transportation Authority of Boston; the bus system serving Worcester, Massachusetts; the Rhode Island Public Transit Authority; the Southeastern Pennsylvania Transportation Authority of Philadelphia; the Metropolitan Transit Authority of Houston, Texas; the Southwest Ohio Regional Transit Authority of Cincinnati; the Southern California Rapid Transit District of Los Angeles; the San Diego Metropolitan Transit Development Board; the New Jersey Transit Corporation; Montgomery County Maryland; the Transit Authority of River City of Louisville; the Bi-State Development Agency of St. Louis; and AC Transit of Oakland, California.

The aggregate value of equipment transferred to private corporations in these transactions is approximately $212 million. This represents the local investment in the new buses or subway cars involved since the Treasury regulations do not permit transit agencies to transfer any tax benefits attributable to a federal grant. The return to the transit system has varied depending upon whether a bus or a subway car was involved. APTA estimates that the aggregate return to the transit authorities was approximately $35 million. The size of the tax benefit to the private corporation would depend on its own financial circumstances, but we estimate that the overwhelming bulk of the benefits was passed through to the transit authorities.

Safe harbor leases for transit have, therefore, had a relatively insignificant revenue cost to the United States Treasury. In fact, the aggregate value for the entire industry is only a small fraction of some of the huge, individual, corporate transactions already completed under the safe harbor leasing provision. To the transit systems involved, ranging from large rail systems to small bus operations, this additional infusion of capital has provided the funding for additional rolling stock and the maintenance of critical services. In other words, safe harbor leasing for transit is accomplishing the very goals Congress had in mind when it made this financing technique available to transit.

Finally, it is important to note that many other transit authorities have reworked their equipment acquisition programs, sometimes at significant public cost, to comply with the safe harbor leasing provision in reliance on its continuation. For example, the MTA of New York acting in concert with the State of New York has fashioned a five-year, $7 billion capital improvement program, which assumes the continued availability of safe harbor leasing as a contributor of $5 hundred million in equipment financing. Other authorities considering the use of safe harbor leasing include the rail and light rail transit systems serving Philadelphia, Chicago, Cleveland, Boston, Atlanta, Miami, and San Diego.

It has also become clear that safe harbor leasing for transit is a program that, if continued, can benefit large, medium, and small bus systems. For instance, the bus systems serving Oklahoma City, Oklahoma; Memphis, Tennessee; Jacksonville, Florida; Fort Wayne, Indiana; Denver, Colorado; Santa Clara County, California; Portland, Oregon; and many others have all made a serious effort to take the necessary steps to avail themselves of the opportunities provided by safe harbor leasing.

The recent announcement that the safe harbor leasing provision for transit might be repealed or substantially modified has placed in doubt the hopes of these and other transit systems to improve their bus and rail car acquisition plans through the use of this financing technique. On behalf of the public transit industry, I urge that safe harbor leasing for transit vehicles be retained. Thank you very much.

CITY OF CINCINNATI COUNCIL,
Cincinnati, Ohio, April 9, 1982.

Hon. JOHN SALMON,
Chief Counsel, Committee on Ways and Means,
Washington, D.C.

DEAR MR. SALMON: Enclosed please find a copy of my prepared statement regarding the Economic Recovery Tax Act of 1981. Although I appeared before the Committee on Ways and Means on Wednesday, March 31, 1982, at the Committee's hearings on the Administration's revenue proposals, I did not have the opportunity to present my statement.

I would appreciate, however, the inclusion of this statement in the printed record of proceedings. Thank you for your attention to this matter.

Sincerely,

PETER STRAUSS.

Enclosure.

STATEMENT OF PETER STRAUSS, CITY COUNCIL, CINCINNATI, OHIO

The Economic Recovery Tax Act of 1981 authorized municipalities to sell depreciation applicable to mass commuting vehicles.

On December 31, 1981 the City of Cincinnati, Ohio entered into a sale/leaseback arrangement with the First National Bank of Cincinnati involving eighty-seven buses used for mass transit purposes. The bank bought the buses from the City for $2,472,769.00 supplying $312,769.00 of its own funds and $2,160,000.00 raised in the municipal bond market. The sale of tax exempt securities is required as a condition of the sale of depreciation on mass commuting vehicles.

The bank can depreciate the buses over five years, gaining those tax benefits. The City, for its part, has effectively bought $2,472,769.00 of transit equipment for $2,160,000.00.

The bonds are secured by a trust indenture and the lease agreement between the City and the bank.

The bank pursuant to Internal Revenue Service Code Section 168(f)(8)(A) becomes owner of the Equipment solely for federal income tax purpcses. The City retains all other rights, title and interest in the equipment including the right to operate the equipment without bank interference. The lease provides that upon the expiration of the term of the lease (May 15, 1995), the City shall purchase the bank's interest in the Equipment for an aggregate amount of $1.00.

The City of Cincinnati opposes the repeal of the right to sell depreciation on mass commuting vehicles as granted by the Economic Recovery Tax Act of 1981. However, we would not oppose amending the Act to eliminate the required sale of tax exempt securities as a condition of the sale of depreciation.

Chairman ROSTENKOWSKI. Mr. Seidman, you may proceed.

STATEMENT OF L. WILLIAM SEIDMAN, VICE CHAIRMAN, PHELPS DODGE CORP.

Mr. SEIDMAN. Thank you, Mr. Chairman. I appreciate the opportunity to appear before your committee.

My name is L. William Seidman. I am vice chairman of Phelps Dodge Corp., the Nation's second largest copper producer. As a member of this panel, it is my purpose to attempt to correct some of the misconceptions that I believe have arisen with respect to the safe harbor leasing provisions, and I shall refer in my testimony to a study by Arthur Andersen & Co. on safe harbor leasing, which I believe has been made available to all the members of the committee.

Let me start with the misconceptions and put before you our view of why they are misconceptions. It has been said that safe harbor leasing is a subsidy and Congress did not intend subsidies for corporations. The fact is that Congress in passing the recent tax act went out of its way to indicate that it wanted to subsidize capital investment, and it did it through improving the depreciation deductions and through an improved investment tax credit.

Safe harbor leasing merely provides the same benefit to companies who are in a loss position or cannot use up all of the credits as it does to companies that are more profitable. No benefit goes to any company that does not invest in new capital equipment, and what the safe harbor leasing provisions do is make the effects of these benefits even across the field so that both companies in profit and loss positions can use them.

Second, it has been said that the major beneficiaries of safe harbor leasing are inefficient, loser industries. Again, this is not the case. The fact is, as the Arthur Andersen study shows, almost all the industries involved are those that over the years have been profitable. At the moment, they are less profitable, I believe for two reasons.

One is the current recession, with which we are all familiar, and secondly, they are capital-intensive industries. They are such industries as steel, automobiles, airlines, railroads, mining, paper, cement, and others. That is a list long enough to wonder why all those industries are in a distressed position, and the answer is that they are capital intensive and we have had a long period of high

inflation, and inflation erodes capital. No management, however skilled, can prevent that under those types of conditions.

So what has happened to these industries is that the previous policies, which have caused our economy to have inflation far above any experienced previous in history, is the reason that these industries are now short of capital.

Another misconception is that the safe harbor leasing is a giant ripoff and that the benefits go to profitable companies. Again, the Arthur Andersen study shows that this is not true. The average price that is being paid in the leasing as a downpayment is 25 to 35 percent of the total cost of the equipment, and the Arthur Andersen study shows that 95 percent of the tax benefits are going to the distressed industries, the very ones that were intended to be helped by these provisions.

A Treasury study comes up with a somewhat lower figure, 84 percent. Overall I would say that somewhere around 90 percent of the benefits go to the distressed industries, and in our own case, that was our computation. This contrasts with somewhere around 50 percent of the benefits which were being transferred under the previous law, known as leverage leasing.

It has been said that safe harbor leasing allows some profitable corporations to eliminate completely their current tax liability and even to get carry-backs. This, of course, is in a very unusual case, although it is possible. Should it be felt that this is an abuse, it would be easily corrected by providing a cap with respect to the lessors who have used the benefit beyond what Congress might feel is justifiable.

It has also been said that safe harbor leasing is of no benefit to small business. At the current moment I believe that is a true statement because since the chairman of the Senate Finance Committee made his famous February 19, cutoff date, it has been almost impossible for any small companies to go forward with leasing. It is simply so uncertain that transactions are not being completed.

Even in companies of a larger size such as ours, we find it very difficult at the moment to continue with the uncertainty created by that statement. Nevertheless, looking at both the Treasury studies and the Arthur Andersen studies, one sees that a great number of small companies have availed themselves of these provisions and many more would if, in fact, they are given an opportunity by continuing the law.

It has also been said that the repeal of safe harbor leasing is sound economic policy at this time because it would greatly reduce the large Federal deficits over the coming years. The numbers with respect the amount of tax revenue losses are pretty well agreed. They are certainly not large compared with the kinds of deficits that are being talked about. Nevertheless, I share the concern in this regard.

However, we are in a serious recession, and at least as far as we can see, there is no sign of light at the end of the tunnel. We do not see any recovery in our industry at this time. To repeal safe harbor leasing now would cut the cash flows of the companies involved and directly cut their capital spending at a very time when it is needed to spur recovery from this recession and create jobs.

It is hard to think of any action that would more directly and immediately cost more jobs than to repeal the safe harbor leasing provisions and thereby curtail capital spending.

Finally, Mr. Chairman, I would like to say a couple of words about our own company and our own industry. As I said, we are the second largest copper producer in the United States. The first and third largest copper producers are owned by oil companies. They automatically have the benefits of safe harbor leasing, whereas we who have to compete with them do not.

Over a period of time it will be very difficult, if not impossible, for us to stay as an independent company under those types of conditions where our capital is going to cost us 30 or 40 percent more than our competitors. In addition, we will be without safe harbor leasing at least for a period accumulating larger and larger losses and credits, which would make us a target for takeover.

So on the basis of fairness and competition within the industry, safe harbor leasing is essential to our independent existence.

I want to thank the committee for listening to my presentation. We hope that we can deal with what we believe are some misconceptions further in the question period, and I would like to introduce Mr. William Penick, senior partner in Arthur Andersen, on my right, to testify next.

[The prepared statement follows:]

STATEMENT OF L. WILLIAM SEIDMAN, VICE CHAIRMAN, PHELPS DODGE CORP.

Mr. Chairman and members of the committee, I am L. William Seidman, Vice Chairman of Phelps Dodge Corporation, the nation's second largest copper producer. As a member of this panel, it is my purpose to attempt to correct some of the misconceptions that have arisen with respect to the safe harbor leasing provision contained in the Economic Recovery Tax Act. In doing so, I shall refer to a recently completed study by Arthur Andersen & Company on safe harbor leasing activity in 1981. I believe a copy of the study has been given to each member of the Committee. I respectfully request that the study and my complete written statement be made a part of the hearing record. Mr. William Penick, Senior Partner, Legislative Tax Policy, Arthur Andersen & Company is with me today to respond to questions about the study.

The safe harbor leasing provision is, in all probability, as misunderstood and unjustly maligned as any tax provision ever enacted by Congress. Until the following misconceptions regarding it are corrected, it will be difficult for Congress to sensibly address whatever remedial legislation may be needed.

1. It has been said that safe harbor leasing is a subsidy and Congress did not intend to provide subsidies for corporations.

The fact is that Congress' very purpose in providing tax benefits such as accelerated depreciation (ACRS) and a more liberal investment tax credit (ITC) was to encourage new investment through a tax incentive or "subsidy." Safe harbor leasing is simply the means by which this incentive (or subsidy) is made available to all businesses, regardless of their tax position. It is important to remember that safe harbor leasing provides no benefits whatsoever to "loss companies" which are not investing in new equipment. It provides no greater subsidy to "loss companies" than that provided by ACRS and ITC to concerns with current taxable profits. Safe harbor leasing keeps the cost of capital on an equal basis for all corporations, profitable and unprofitable.

2. It has been charged that the major beneficiaries of safe harbor leasing are inefficient "losers" who do not need or deserve this type of help.

The fact is, as shown by the Arthur Andersen Study, that most sellers (of tax credits and deductions) are well established companies in the so-called "distressed industries." These firms have been profitable in the past but, due to reduced earning levels in recent years, have ITC carryovers and current U. S. operating losses which make them unable to use additional tax benefits related to investment in new equipment.

Thus, the primary beneficiaries of safe harbor leasing are capital intensive basic industries such as steel, automobile, airline, railroad, mining, paper and cement. This is a list impressive enough to raise the question as to why such basic industries are all nonprofitable and short of capital. The answer is that all of these industries are the principal victims of government policies that produced our record-high inflationary economy. Inflationary policies have produced the current recession which also hits hardest at the basic industrial sector. Inflation erodes capital regardless of what management skills are present.

3. It has been claimed that safe harbor leasing is a giant "rip-off" in which some 70 to 80 percent of the benefits are snapped up by the profitable buyer/lessor.

Those who make this charge evidently confuse the value of the property involved with the present value of the tax benefits transferred by the buyer to the seller; these have generally ranged from 20–30 cents per dollar of asset. The fact is, as the Arthur Andersen Study as well as the Treasury study shows, that, from the standpoint of the seller, the tax benefits have been selling at or even above the present value of the tax benefits transferred.

Arthur Andersen concludes "the sellers are receiving better than 95 percent of the maximum tax benefits associates with equipment ownership through safe harbor leasing." The Treasury study indicates that 84 percent of the benefits are going to the lessee. Based on these two findings, it seems reasonable to assume that somewhere around 90 percent go to the lessee. This contrasts with the transfer of 50 to 60 percent under "leveraged leasing" which has existed in the tax law for many years. Under safe harbor leasing, according to Arthur Andersen, buyers are obtaining yields of about one percentage point above a break-even yield.

4. It has been emphasized that safe harbor leasing permits a large number of profitable corporations to eliminate completely their current tax liability.

Some profitable corporations may have eliminated their tax liability. However, for buyers that responded to the Arthur Anderson Study, current tax liability was reduced by about 40 percent. The fact is that buyers did not get a free ride since they had to pay the sellers rather than the IRS. The selling companies receive the tax benefits indirectly through the lessors, rather than directly as would be the case if ITC and ACRS deductions were made refundable on the part of the government. Should Congress wish to remove the possibility of buyers using safe harbor leases to eliminate their tax liability, it can easily be done through a limiting provision with respect to the percentage reduction allowable.

5. It has been charged that safe harbor leasing was slipped into the Economic Recovery Tax Act of 1981 at the last minute by special interest lobbying.

The fact is that the adoption by Congress of safe harbor leasing was the culmination of an extensive effort by the industries represented in this panel, and others, to obtain tax law amendments which would permit a corporation to utilize the investment tax credits it was legitimately earning, but unable to use at the moment because of limited taxable income. When the Treasury Department became aware of the problems of these basic industies, and the fact that passage of the accelerated depreciation proposal known as "10–5–3" would temporarily hurt rather than help their situation, Treasury developed safe harbor leasing as an answer to the problem.

It is true that, due to time limitation, safe harbor leasing did not receive attention from a large number of members of Congress. Their attention is now sharply focused and I believe that a full review should reaffirm this approach as a sound method of assuring that this country's basic industries are treated fairly and that safe harbor leasing is a sound economic policy for the current recessionary period.

6. It has been said that safe harbor leasing is of no benefit to small business.

The fact is that small business is benefiting from leasing, as both Treasury data and the Arthur Andersen Study have indicated. Many small businesses may not have participated early on because of lack of knowledge about the provision. However, by the end of 1981, brokers catering to small businesses were swinging into high gear. Unfortunately, fear that Congress may repeal or severely restrict safe harbor leasing retroactive to February 19, 1982, has effectively dried up the market for small businesses, including farmers. This problem could be corrected if this Committee would indicate that any legislation which might affect safe harbor leasing would be prospective rather than retroactive in nature.

7. It has been claimed that repeal of safe harbor leasing is sound economic policy because it will greatly reduce huge federal deficits over the next few years.

I fully share the concern over deficits but the fact is that repeal of safe harbor leasing in an effort to reduce them would be bad public policy at this time. The nation is in a serious recession and recovery is not yet in sight. To repeal safe harbor leasing now would cut a significant part of the cash flow and thus the capi-

tal spending of this country's basic industries at a time when capital spending is needed to spur recovery from the recession and create jobs.

These distressed industries (which the Arthur Andersen Study shows are the major beneficiaries of the program) are all in tight cash positions. Less cash flow from leasing will mean almost a dollar-for-dollar loss of capital expenditures at this time. In addition, as members of the panel will emphasize, the cutback of investment plans will result in lower productivity growth in the future.

In my judgment, the Treasury estimates of the revenue impact of safe harbor leasing for future years may be on the high side. Every company represented at this table—and I dare say the vast majority of companies engaging in safe harbor leasing—intend to be profitable again before long. We would not be making the investments that generate the tax credits and deductions if we believed otherwise. When these companies are profitable, they will be able to take the tax credits and deductions which investments generate and the net revenue loss estimated by the Treasury will be only a matter of timing.

In closing, I wish to add a specific report regarding my own company. During 1981, Phelps Dodge spent $147.1 million on new capital expenditures. Of this amount, approximately $76.9 million qualified under the safe harbor leasing provision. In November and December, 1981 we entered into two transactions in which we transferred, pursuant to safe harbor leases, the tax benefits associated with substantially all such qualifying property to a third party. Through these two transactions, Phelps Dodge obtained over $22 million in cash, about 80 percent of the total value of the tax benefits associated with the property.

All of the funds generated from these two transactions will be used to finance capital expenditures which otherwise would have been postponed, or perhaps never made at all. These capital expenditures are critical for us to maintain or expand our U. S. operations, or to comply with government-mandated clean air standards. Assuming we have sufficient funds, we have budgeted qualifying capital expenditures in 1982 of approximately $150 million. In our present financial condition, our company can not prudently borrow additional funds for capital investment. The leasing provisions which were in effect prior to the enactment of the Economic Recovery Tax Act did not provide a viable alternative for us because, in large part, our capital expenditures relate to property which could not satisfy the overly stringent tests previously imposed for leases by the Internal Revenue Service.

The copper industry is currently confronting dire economic conditions. Two of copper's principal markets, automobile manufacturing and housing construction, are in deep recession. The price of copper, in real terms, is as low as it was in the depression years of the 1930s. It should be noted that roughly half of the annual domestic production of copper emanates from mines now owned by oil companies. Such companies automatically achieve the equivalent of safe harbor leasing since their copper losses can be absorbed and their overall profitability enables them to take advantage of ACRS deductions and ITCs. It is clear that without safe harbor leasing, the nation's remaining independent copper companies would find themselves at a severe competitive disadvantage. In addition, companies which accumulate unusable tax benefits become merger targets for those companies with substantial taxable income. I cannot believe that Congress wishes to encourage further mergers of this kind in the copper industry.

In summation, I believe that the public and, perhaps, even the Congressional perception of leasing is not as fully and fairly developed as it should be. Hopefully these hearings will bring a better understanding of the economic desirability of safe harbor leasing. We urge the Committee to move soon to correct any demonstrated abuses that have arisen but, in so doing, to retain the basic thrust of the provision.

Chairman ROSTENKOWSKI. Mr. Penick, you may proceed.

STATEMENT OF WILLIAM PENICK, SENIOR PARTNER, ARTHUR ANDERSEN & CO.

Mr. PENICK. Thank you, Mr. Chairman.

My name is William Penick. I am senior partner for legislative tax policy with Arthur Andersen. Our firm was engaged about 2 months ago to conduct a survey of a selected group of taxpayers which have utilized safe harbor leasing under last year's Tax Act.

While our clients for this survey consisted of companies who obviously were interested in safe harbor leasing, the design and con-

duct of the survey and the identification of companies to be surveyed were entirely within our control. We attempted to select companies using sound statistical sampling techniques and to conduct the survey in an objective and independent manner.

The objectives of the survey included attempting to ascertain first why safe harbor leasing was chosen; second, the impact that safe harbor leasing was having on investment decisions; and third, the effectiveness of the safe harbor leasing approach as compared with other possible sources of financing.

In the relatively short time we had to conduct the survey, we selected 75 companies through random sampling techniques and were able to conduct personal interviews with top corporate executives with 42 of this group. Thirty-one of these were lessees or sellers of tax benefits, and 11 were lessors or purchasers of tax benefits.

The results of our survey are reflected in our report, which is dated March 15, which has been submitted to the committee for the record of these hearings. I will not repeat here all of the conclusions stated in that report, but I will attempt to answer questions you may have about them later.

Subsequently on March 26, the Treasury Department released a preliminary report on safe harbor leasing activities based on their analyses of information, returns covering about 2,000 leases filed with the Internal Revenue Service in January. While the Treasury survey was obviously based on a much broader data base than ours, we believe the fundamental findings are consistent with ours.

Essentially our study concludes that most companies using safe harbor leasing were in low profit or loss positions, they were in depressed industries and entered into leasing transactions because of their inability to utilize currently the benefits from the investment tax credit and accelerated cost recovery deductions.

While the precise answers depend on assumptions and methods used to analyze the data, we concluded that lessees in 5- to 10-year leasing transactions were receiving between 85 and 95 percent of the value of the benefits sold, while the Treasury study indicated an overall average of about 84 percent.

From the viewpoint of lessors or the purchasers of tax benefits, our sample indicated that benefits purchased were eliminating about 40 percent of the tax liabilities of the companies purchasing the benefits.

In response to questions that we asked of the companies being surveyed about the effect of the repeal of safe harbor leasing, about half of the respondents said that repeal would not affect their investment decisions in the future, while another half expected repeal would result in a reduction or delay in expenditures currently planned

Whether repeal would cause an increase in the level of merger and acquisition activities also received a divided response. Some companies thought it could be a significant factor, and others thought it would not be that important. A very significant number of the companies surveyed said that repeal would cause them to revert to traditional leverage leasing to finance new capital additions.

This is an extremely brief overview of the results of our survey, but I think perhaps it is better to leave time later for questions on that.

Thank you.

[The report referred to follows:]

REPORT ON
SURVEY OF SELECTED PARTICIPANTS
IN SAFE HARBOR LEASE TRANSACTIONS PURSUANT TO INTERNAL REVENUE CODE SECTION 168(f)(8)

MARCH 15, 1982

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March 15, 1982

REPORT ON SURVEY OF SELECTED PARTICIPANTS IN SAFE HARBOR LEASE TRANSACTIONS

Summary of Findings

To facilitate the realization of the increased benefits from both the investment tax credit (ITC) and accelerated cost recovery deductions (ACRS), the Economic Recovery Tax Act of 1981 (ERTA), contains certain provisions that allow the transfer of credits and deductions related to investments in new equipment. While leasing has been an accepted part of our Federal tax system for many years, these provisions, known as safe harbor leasing rules, are a significant extension of prior tax policy and principles. It is not surprising that they have generated much discussion and controversy. Much of the discussion has centered around the impact of safe harbor leasing on investment decisions, concerns about inefficiency and excessive benefits to those buying tax benefits, and speculation about the consequences of repealing these provisions.

This survey was conducted in order to develop information about transactions that would be useful to those engaged in these discussions. Questionnaires were completed by various sellers (31) and buyers (11) with respect to their actual transactions and their decision making processes.

The primary findings of the survey include the following:

1. Inability to utilize ITC and ACRS deductions currently is the primary reason that sellers transfer these benefits. There was almost no indication that benefits which could be utilized by sellers, even though at a lower level, are being transferred.

2. Sellers are receiving better than 95% of the maximum tax benefits associated with equipment ownership through safe harbor leasing according to analysis based on the assumption that tax deductions could be utilized currently. Since most would not otherwise realize the benefits of deductions until 1983 or later, some sellers may actually be receiving more than what the present value of the tax benefits are to them.

3. Most sellers are well established companies in the so-called "distressed" industries, and are not start-up businesses. They have been profitable in the past but, due to recently reduced earning levels, have ITC carry-overs and current U.S. operating losses which make them unable to use additional tax benefits related to investment in new equipment.

4. Most sellers have alternative sources of financing and many have adequate amounts of cash. This indicates that the safe harbor leasing rules are not being used mainly by weak, poorly managed companies on the brink of failure. Funds realized from selling tax benefits averaged 15% of the total of all capital expenditures. This has obviously freed up capital for other business needs.

5. Most sellers (71%) have not revised their capital expenditure budgets as a result of safe harbor leasing. Reasons for this are: (1) investment decisions reflect business needs, not just tax benefits; (2) the status of tax incentives and safe harbor leasing is uncertain; and (3) plans for material capital expenditures require long lead time and planning.

6. Many sellers plan to make significant use of safe harbor leasing in 1982 and later.

7. While nearly half of the respondents (45%) said that repeal of safe harbor leasing would not affect their investment decisions in the future, 42% said repeal would result in a reduction or delay in expenditures currently planned.

8. Whether repeal of safe harbor leasing would cause an increase in the overall level of merger and acquisition activity, received a divided response from both buyers and sellers.

9. If safe harbor leasing is repealed, a significant number of the companies surveyed would expect to utilize traditional leveraged leasing to finance plant additions and equipment purchases.

10. Buyers in the sample group reduced their tax liability an average of about 40% by purchasing tax benefits.

11. Buyers evaluate the credit of sellers before entering into safe harbor leases. This acts as a check against tax-motivated investments by weak companies.

12. Buyers are analyzing safe harbor leases as alternative investment opportunities. The yields generally received are comparable to those available on tax-exempt municipal bonds.

Conclusion

If an objective of safe harbor leasing is to assist investment by companies with low earnings and those in distressed industries, the survey indicates it is working. The majority of the companies surveyed that sold tax benefits could not use those benefits currently, either because of depressed conditions or other factors. The prices received by sellers of tax benefits under safe harbor leases seem to be reasonable and do not indicate an exorbitant profit by the purchasers of such benefits.

Many factors bear on a company's decision to make an investment but the survey indicates that safe harbor leasing has not been a significant one to date. This is not surprising since most of the transactions surveyed involved equipment acquired before the enactment of those rules as part of ERTA.

Funds received from the sale of tax benefits under safe harbor leases have clearly improved the cash position of the companies surveyed, but there is a strong indication that these companies could have obtained funds elsewhere, although perhaps at a higher cost.

If safe harbor leasing were repealed, there is little indication that this by itself would trigger greater interest in mergers and acquisitions. There is indication that, if safe harbor leasing were repealed, traditional leveraged leasing would be used more extensively by a substantial number of companies.

With respect to the purchasers of tax benefits, allegations that many companies are completely eliminating their corporate taxes seem unfounded. Although one company did report a 100% reduction of its current corporate taxes, on the average, from the companies surveyed, roughly 40% of their current corporate taxes were eliminated through benefits purchased under safe harbor leasing.

1. Survey Report

SURVEY OF SELECTED PARTICIPANTS IN

SAFE HARBOR LEASING TRANSACTIONS

Introduction

As a major part of the Accelerated Cost Recovery System (ACRS), contained in the Economic Recovery Tax Act of 1981 (ERTA), Congress provided a mechanism for assuring that a transaction between a user of property and a financing party would be treated as a lease for federal income tax purposes. The stated purpose of this mechanism, referred to as safe harbor leasing, was to facilitate the transfer of the benefits of the investment tax credit and deductions under ACRS from one taxpayer to another.

As stated in the "General Explanation of the Economic Recovery Tax Act of 1981," (General Explanation), prepared by the staff of the Joint Committee on Taxation:

> Although the flexibility provisions under ACRS and extension of the carryover period for net operating losses to 15 years will enable some companies to avoid loss of tax benefits, many capital intensive companies will still be unable to utilize fully their tax benefits. Moreover, even if the tax benefits can be carried over and used in later years, in present value terms the tax benefits are reduced. The safe-harbor leasing provisions under the Act are designed to address this. ("General Explanation," p.103.)

Thus it was intended that, through the increased use of leasing, a concept that has been used extensively in the past to transfer tax benefits associated with the ownership of property, certain companies (lessees or sellers) unable to utilize tax benefits could more easily transfer them to other companies (lessors or buyers) which could utilize them currently.

For many reasons, safe harbor leasing has received a significant amount of attention. While the concept of leasing is not new, the safe harbor leasing rules are a departure from traditional notions of leasing and tax principles developed over many years which tend to discourage the transfer of benefits from one taxpayer to another. In addition, the relaxation of the leasing rules and the special transition rules contained in ERTA led to the consummation of a large number of significant safe harbor leasing transactions that were widely reported by the media and variously lauded and criticized.

To provide information regarding the volume and details of these safe harbor leasing transactions, certain information returns must be filed by the participants with the Internal Revenue Service. These returns, when analyzed, will indicate the volume of leasing transactions, their structure, and the property involved in them. Our Firm was engaged to conduct a survey to obtain additional information regarding the participants in safe harbor leasing. This survey has attempted to gain information concerning the size and types of taxpayers that have used the safe harbor leasing rules and their motivation to do so.

Survey Procedures

The survey was conducted through direct interviews by Firm personnel from a number of our U.S. offices with company officials who were involved in arranging safe harbor lease transactions. A list of companies that were reported to have entered into safe harbor lease transactions was compiled. This list was compiled from several sources including publicly reported transactions, names of companies provided by our offices, and information from leasing companies and investment bankers. An identifying number was assigned to each company and selections of those companies to be surveyed were made without reference to their identity, using a table of random decimal digits generated by the Bureau of Transport Economics and Statistics, Interstate Commerce Commission.

The total companies included and the sample selected were as follows:

	Total Companies	Sample Selected	Respondents
Sellers	207	60	31
Buyers	63	15	11
Total	270	75	42

Each company selected was asked to complete a questionnaire, but not all companies selected agreed to cooperate. Various reasons were given for declining to participate in the survey including the controversial nature of the subject, concern about confidentiality and lack of interest in the survey. In

some cases not all questions were answered by the respondent. This accounts for the fact that, in some of the Tables appearing in this report, the number of respondents indicated is less than the number of participants in the survey.

Questionnaires were designed to elicit information in four major areas: (1) taxpayer profile; (2) general information; (3) transaction description; and (4) property description. Copies of the questionnaires discussed with sellers and buyers are included in Appendices A and B.

RESULTS OF SURVEY SELLERS (LESSEES)

Taxpayer Profile

The companies interviewed represented 13 different businesses or industries. The survey indicated that a significant percentage of the sellers were from so-called "distressed" industries. Forty-eight percent (48%) of the sellers interviewed were in airline transportation, mining, paper products, railroad transportation, steelmaking, and savings and loan associations. The industries represented are summarized as follows:

Table 1

Seller's Industry/Business	Number of Respondents	Percentage
Airlines	4	13%
Banking/Savings & Loan	8	26
Mining	3	10
Paper Products	2	6
Railroads	1	3
Steel	2	6
Utilities/electricity generation	4	13
Others	7	23
	31	100%

Since many of the names contained in the list from which the sample was drawn were obtained from information available to the public, it was anticipated that many of the selected companies would be large, publicly traded companies. We were able to obtain information from other sources, however, and were able to include a number of smaller companies in the list. This is reflected in the following profile of the sample.

Table 2

1981 Gross Assets of Sellers

Gross Assets (in Millions)	Number Respondents	Percentage
Under $25.0	2	6
$25.0 - 100.0	4	13
$101.0 - $500.0	4	13
$501.0 - 1,000.0	5	16
Over $1 billion	16	52
	31	100%

With respect to the profitability of these companies, most indicated relatively small profits and no tax liability. Table 3 indicates the number of respondents classified in various brackets based on 1981 gross revenues and net income. Table 4 indicates the level of U.S. tax liability of the respondents for 1981.

Table 3

	1981			
	Gross Revenues		Net-Income	
Amounts (In Millions)	No. of Respondents	%	No. of Respondents	%
Under $25.0	3	10	17	59
$25 - 100.0	7	23	3	10
$101 - 500	7	23	9	31
$501 - 100	1	3	-	-
Over $1 Billion	13	41	-	-
	31	100%	29	100%

Table 4

	U.S. Tax Liability					
	1981		1980		1979	
Amounts (In Millions)	No. of Respondents	%	No. of Respondents	%	No. of Respondents	%
None	14	52	13	50	9	35
$0 - 5.0	7	26	8	31	11	43
$6.0 - 25.0	5	18	2	8	3	11
Over $25.0	1	4	3	11	3	11
	27	100%	26	100%	26	100%

Generally speaking, the companies interviewed were publicly held (71%), over ten years old (86%), and employed, on average, about 14,100 worldwide and 12,500 in the United States. The percentage of these companies' employees that had been laid off was about the same as the national unemployment rate.

Table 5

U.S. Employees of Sellers

Total Employed	387,229
Total Laid-off	32,335
% Laid-Off (average all respondents)	8.35%

Finally, with respect to the volume of safe harbor leasing by these companies, the total cost of property involved in safe harbor leases by the respondents was $2.3 billion. This represents an average (mean) volume of $76.6 million per company. Volume by particular companies ranged from a low of $186,000 to a high of $350 million, with over 92% of the volume being accounted for by one-half of the respondents. For the remaining one half of the sellers, the average (mean) volume was $11.8 million per company.

General Information - Sellers

Part B of the questionnaire was designed to determine the role safe harbor leasing played or is expected to play in the investment decisions of the seller companies. This part also

requested information concerning why the company decided to enter into a safe harbor lease and whether it expected to do so again. Finally, we asked the company to speculate as to the effect repeal of the safe harbor lease provisions might have.

The primary reason the sample companies engaged in safe harbor leases was that they were not able to fully utilize the tax benefits associated with ownership of the property. All of the respondents said that inability to utilize the tax benefits currently was an important factor in their decision and 90% indicated it was "very important." Other significant factors were their plans for future investments (perhaps indicating concern for their ability to utilize tax benefits in the future) and their need for cash. While the lack of other attractive sources of financing was somewhat important, most (59%) said that it was not a factor. This is corroborated by the fact that 52% said they would have borrowed the funds if safe harbor leasing had not been available.

Table 6 summarizes the responses to the question; "Of what importance were each of the following factors in your decision to enter into a safe harbor lease transaction(s)?"

Table 6

Importance of Various Factors

	Not Important	Somewhat Important	Very Important
Can't Utilize ITC and/or ACRS (2)*	-	3	26
Future plans (2)	6	10	13
Need cash (2)	11	5	13
Lack of alternative financing (2)	17	5	7
Financial reporting (1)	20	9	1

* Amounts in brackets ( ) indicate companies with no response.

Clearly, the principal factor in the sellers' inability to use additional ITC and ACRS deductions is that they already have ITC in excess of the amount they can utilize currently to offset Federal tax liability, if any. Sixty-six percent (66%) said that the existence of ITC carryovers contributed "very much" to their inability to utilize ACRS tax benefits currently. In addition, 87% said they did not expect to be able to use them (ITC carryovers) until after 1983.

Interestingly, while 67% attributed their inability to utilize additional tax benefits to operating losses in their U.S. operations (54% said it contributed "very much"), more than 72% said that they did not have net operating loss carryovers. This would seem to indicate that these companies were more profitable in the past and have just recently incurred losses.

The existence of foreign tax credit carryovers and the ability to claim percentage depletion or to have some income taxed at favorable capital gains rates were not significant factors in the inability to obtain full benefit (i.e. at a 46% marginal rate) of the tax benefits. Those that considered foreign tax credit carryovers to be a very important factor also had operating losses in the U.S. as well as ITC carryovers.

Table 7 summarizes the responses of the companies when asked to indicate the extent to which certain factors contributed to their inability to utilize additional ITC or obtain full benefit from ACRS deductions.

Table 7

Contribution of Certain Factors

to Inability to Use Tax Benefits

	Not at all	Some	Very Much
Current U.S. losses	10	4	16
Net operating loss carryovers	21	2	6
Investment tax credit carryovers	5	5	19
Foreign tax credit carryovers	25	2	2
Alternative tax on capital gains	27	2	-
Percentage depletion	24	4	-

Many safe harbor leases occurred in order to take advantage of the transition rules which, for a limited time, permitted safe harbor leasing of property acquired earlier in 1981. For this reason, it is not surprising that most sellers (58%), indicated they had already purchased the property and therefore would not have leased the property in the absence of the safe harbor lease provisions. Most sellers, however, plan to

use safe harbor leasing again in 1982 and 1983 and expect it will generate significant amounts of cash for them.

Table 8 summarizes the responses regarding whether, and the extent to which, sellers plan to utilize safe harbor leasing in 1982, 1983 and thereafter.

Table 8

Plan to Use Safe Harbor Leasing

in the Future

	Yes			
	%	Amount*	No (%)	Don't Know (%)
1982	88	$971.0	6	6
1983	68	$877.0	13	19
1984 and later	53	$323.0	10	37

* Total payments (in millions) expected to be received by sellers with respect to the transfer of tax benefits.

It should be noted that, if one assumes that in a typical 10 year lease transaction the seller would receive a payment of about 25% of the total cost of the equipment, the amounts in Table 8 would indicate plans by these sellers to use safe harbor leasing in the future involving the following amounts of equipment:

	Estimated Equipment Cost
1982	$3.9 billion
1983	$3.5 billion
1984 and later	$1.3 billion

It has been argued that one of the benefits of the safe harbor lease provisions is the stimulus it provides for increased investment in equipment. It is not possible, in most cases, for a company to determine whether the proceeds from a safe harbor lease were used directly in the acquisition of additional equipment. Money is fungible and cash used for a particular expenditure cannot really be traced back to a particular source. Questions were asked, therefore, to attempt to determine by somewhat indirect means whether the proceeds of safe harbor leasing were likely to be used for additional investment. The responses to these questions are not conclusive.

In general terms, safe-harbor leasing was a material source of additional cash for the sellers that were interviewed. They indicated that the proceeds received amounted to, on average, 15% of the total cost of all capital expenditures for equipment during 1981. The payments received ranged from as low as 3% and 4% of total capital expenditures (by companies such as utilities with significant expenditures for property under construction and not yet available for safe harbor leasing) to as high as 33%.

Most companies (71%) did not revise (nor do they plan to revise) their capital expenditure budgets for 1981-1985 as a result of safe harbor leasing. Furthermore, nearly half of the companies said that repeal of safe harbor leasing would not materially affect their investment decisions in the future. The most frequent reason given was that investment decisions are

determined by business needs and taxes are only one consideration. Those who said that repeal of safe harbor leasing would affect their investment decisions (42%) uniformly stated they would reduce or delay expenditures now planned.

Various statements have been made concerning the possible impact of repeal of the safe harbor leasing provisions. Some have claimed that repeal would result in an increase in the level of tax-motivated mergers as a means to utilize unused ITC and ACRS deductions. Others have suggested that businesses unable to use additional ITC and ACRS deductions would arrange to transfer them in leasing transactions (such as leveraged leases) under the rules which preceded safe harbor leasing. We asked the companies to express their opinions in this area with respect to the likelihood of increased merger and acquisition activity or increased level of "true" leasing.

More than 96% of the companies that expressed an opinion said that their company would probably not acquire another company while a slightly smaller percentage (85%) thought it unlikely that their company would be acquired by another seeking to utilize the unused ITC and ACRS deductions. For most companies, the repeal of safe harbor leasing would not affect their plans to acquire (89%) or the probability of being acquired by (86%) another company.

With regard to the effect that repeal of safe harbor leasing would have on the level of merger and acquisition activity <u>in general</u>, the responses are not conclusive. In

response to one question, 43% thought that there would be little or no effect. To another question, however, 35% agreed that such repeal would cause an increase in merger activity, and only 26% disagreed.

If safe harbor leasing is repealed, 42% of the respondents expect to increase their volume of traditional (leveraged) leasing. (This group of respondents was responsible for 70% of the total volume of equipment involved in safe harbor leases by the sellers.) Another 45% anticipate no change in their usage of leverged leasing (i.e., they would engage in the same amount of leasing as before). The balance of the respondents (13%) believe their usage of leveraged leasing would probably decrease.

The transfer of ITC to another taxpayer without transferring the ACRS deductions as well (via the so-called "ITC strip lease") has received attention in the media and from Treasury. Current Treasury regulations do not specifically approve this structure of a safe harbor lease transaction. Virtually all of the respondents were aware of this type of transaction and, while 26% would have preferred this structure, only 2% of the transactions reported to us were structured in this manner.

Another area under the safe harbor leasing provisions and current Treasury regulations that is having a limiting effect on the ability of "closely-held" companies to engage in safe harbor leasing is the "at risk" requirements. (Temp. Reg. 5c.168(f)(8)-7(f)). About 16% of the respondents

experienced difficulty in completing a safe harbor lease transaction due to the application of these rules, either because they were closely held or the potential buyer was closely held.

Transaction Pricing - Sellers

Virtually all of the information requested regarding transaction and property descriptions duplicates information reported in greater detail to the Internal Revenue Service on Form 6793, "Safe Harbor Lease Information Return." Analysis of each of these transactions for the companies surveyed would be extremely time consuming and costly and would duplicate the efforts of Treasury and the Internal Revenue Service. For these reasons, a detailed study of transactions completed was not undertaken. Nevertheless, certain information was obtained which may be useful in general terms in understanding the methods used by sellers in determining the value of the tax benefits to be transferred.

Nearly all of the 81 transactions reported to us (98%) were structured as sale-leaseback "wash leases." Under this structure the seller/lessee receives an initial cash payment ("down payment") in an amount determined by negotiation to be the value of the net tax benefits being transferred. From the seller's standpoint, this value is often determined by computing the present value of the ITC and ACRS deductions transferred and the net rental deductions retained under a safe harbor lease. This calculation is complicated and is a function of the seller's after-tax discount rate and an estimate of when it would be able

to use the tax benefits it proposes to transfer. Due to these complexities, presumably, half of the sellers said they determined the amount they would accept by reference to the marketplace, i.e., they would accept the maximum amount offered, no matter how low.

Other companies (50%) used a present value analysis and, on average, assumed an after-tax discount rate of 13.93%. Based on this information we calculated an amount which represents the percentage of the value of the tax benefits which the sellers received. The precise method utilized is more fully described in Appendix C. Briefly stated, in a five-year lease transaction, the sellers received, on average, approximately 97% of the maximum computed present value of the net tax benefits transferred. In a representative ten-year lease transaction, the sellers received approximately 90% of the maximum value of the tax benefits. Concern on the part of buyers regarding their ability to foresee various risks that far into the future may account for the reduced value received by sellers in the longer transactions.

It is important to note that, since most sellers could not utilize their tax benefits currently, the present value of these benefits to them is less than the maximum, i.e., assuming current utilization. For this reason, amounts being realized by the sellers are most likely in excess of the present value of ITC and ACRS deductions to them.

RESULTS OF SURVEY
BUYERS (LESSORS)

Taxpayer Profile

Since buyers are acquiring tax benefits (ITC and ACRS deductions), one would expect that they are profitable, taxpaying companies that have been in existence for more than a few years, (i.e. have some basis for projecting their ability to utilize tax benefits in the future). The responses of the buyers questioned confirm this expectation.

Buyers represented various industries. The significant percentage of service industries (40%) represented may indicate the desire by those companies that are not capital intensive to share in the benefits of ACRS under ERTA. Table 9 summarizes the principal businesses of the buyers.

Table 9

Principal Business of Buyers

Manufacturing	3
Banking	2
Petroleum products	3
Investment management	1
Stevedoring	1
No response	1
	11

All of the companies were more than 10 years old while 82% were publicly traded. The companies in the sample, although tending to be large, exhibited a wide range in size, both in terms of sales and assets. Table 10 indicates the variety in size of the companies questioned.

Table 10

Sales and Assets of Buyers

Amounts per Financial Statements (in Millions)	1981 Sales	1981 Gross Assets
Under $25.0	3	3
$26 - 100	2	-
$101 - 500	1	3
$501 - 1,000	-	-
Over $1 Billion	5	5
Total	11	11

While all of the companies indicated that they have paid federal income taxes in each of the three prior years, the amounts indicated were toward the lower end of the scale, albeit still significant in absolute terms. Table 11 summarizes the tax liability of the buyers according to particular ranges.

Table 11

U.S. Tax Liability of Buyers

Amount Per Tax Return (in Millions)	1981	1980	1979
Under $5.0	5	5	5
$6 - 25	2	1	2
$26 - 100	2	3	2
$101 - 500	2	2	2
	11	11	11

The buyers who completed questionnaires were involved in safe harbor leases on equipment with a total cost of about $2.0 billion. While the average amount per buyer in the sample is $184 million, the volume by a particular buyer ranged from a

low of $1.8 million to a high of $1.6 billion. Excluding these extremes, the average buyer was involved in safe harbor leases totaling $47.1 million in equipment cost. This compares with the average volume of $76.6 million for sellers who were surveyed (see page 11 above).

By entering into safe harbor leases, buyers in the survey were able to reduce their 1981 U.S. corporate income tax liability by amounts ranging from 9% to 100%. The average (mean) reduction in 1981 tax liability for the sample was 40.8%, whereas the median reduction was 28%.

General Information - Buyers

Since the primary economic thrust of the safe harbor lease rules is seller-oriented, fewer questions were asked of buyers than were asked of sellers. The questions that were asked were designed to determine the degree and type of analysis which a buyer performed before entering into a transaction with a particular seller. Also, buyers were asked to give their opinions concerning the impact of the repeal of safe harbor leasing on merger and acquisition activity.

As indicated by the respondents, the buyer-side of a safe harbor lease transaction is viewed as a financial investment. The attractive yield on investment provided by these transactions was the primary consideration of 73% of the buyers. The buyers were asked to rank certain factors in order of their effect on the decision to enter into a safe harbor lease. Table 12 summarizes the results.

Table 12

Ranking of Factors in Decision to Invest in Safe Harbor Lease

Factor	Points*
Attractive yield on investment	27
Source of low cost funds	24
Financial reporting	12
	63 **

* (3 Pts for 1st, 2 for 2nd, etc.)

** Does not total 66 due to incomplete responses by buyers.

Not surprisingly, since buyers view the safe harbor lease as an investment, nearly all (91%) indicated that the creditworthiness of the lessee was a factor in the decision to enter into the transaction. The sole exception involved transactions with affiliated companies. The same percentage of buyers (91%) also required the seller to indemnify them against loss of tax benefits, which indemnity was secured by the general credit of the lessees in 90% of the cases. In addition, other means of security (third party guarantee or security interest in other property) were sometimes required. Other security devices thought to be common, such as letter of credit or escrow arrangements, were not used by the respondents.

Although creditworthiness of the seller was a factor in the decision process, a significant portion of the buyers (44%) said it did not affect the amount they were willing to pay to the sellers for the tax benefits. The explanation given was that,

below a certain level of credit-rating, a buyer was not interested at all in purchasing the tax benefits of a particular seller.

Concern has been expressed that buyers might be diverting funds from their own capital expenditure programs, or other business related investments, and into safe harbor lease transactions. Most buyers in the survey (64%) said that, in the absence of safe harbor leasing, the funds would have been used in the short-term money market or to purchase marketable securities or municipal bonds. Table 13 indicates the most likely alternative uses that buyers would have had for the funds paid to sellers in safe harbor leases.

Table 13

Alternative Uses of Funds

Invested in Safe Harbor Leases

Alternative Uses	% of Respondents
Short-term money market	46
Marketable Securities	9
Municipal Bonds	9
Capital Expenditures	-
Other	36
	100%

Most buyers (73%) did not revise their capital expenditure budgets for 1981-1985, which tends to indicate that the safe harbor lease rules did not cause buyers to reduce or delay their previously planned capital expenditures. In fact, those

that did revise their budgets, indicated they did so in order to increase capital expenditures due to the near-term positive cash flow resulting from safe harbor lease transactions.

With respect to the impact that the repeal of safe harbor leasing would have on the level of mergers and acquisitions, buyers were even more united in their opinion than were sellers. All the buyers said that repeal would have no impact on their company's merger and acquisition plans or the likelihood that their company would acquire others in order to utilize their excess ITC and ACRS deductions. Only 9% thought their company might be the target of another trying to acquire its excess tax benefits. Most of those expressing an opinion (89%) also thought there would be little or no effect on the level of merger and acquisition activity in general if safe harbor leasing were repealed.

Transaction Pricing - Buyers

For the same reasons stated above with respect to the sellers, we have not attempted to duplicate the detailed analysis of safe harbor lease transactions which Treasury and the Internal Revenue Service will be performing. We have made an analysis, however, of two particular safe harbor leasing structures, based on information submitted by the respondents. This analysis attempts to equate the yield from a representative safe harbor lease transaction with the yield available on an alternative investment. This analaysis is appropriate since: (1) buyers analyze safe harbor leases as investments; (2) buyers compare the

yields available on safe harbor leases with those on alternative investments; and (3) by using a "representative" leasing structure rather than a particular transaction, one can eliminate numerous factors that affect and complicate the pricing of the transaction, such as relative negotiating position of each party, the buyer's method of making estimated corporation income tax payments, etc.

There are many factors to be considered in determining the "yield" of a safe harbor lease and many methods to do so. The most popular method used by the buyers in the survey was the sinking fund method, (82%), although other methods were often used in conjunction. Our analysis, described in more detail in Appendix D, used the terminal value rate of return method. Briefly stated, this approach determines the rate of return resulting for a particular downpayment at an assumed after-tax discount rate. One can then determine whether the downpayment made is better or worse than break-even, assuming that discount rate is the appropriate rate.

We analyzed various downpayment levels at three different discount rates and found that the average and the weighted-average downpayments made in transactions for which we had the information would, in representative five-year and ten-year lease transactions, result in rates of return of approximately one percentage point better than break-even for a buyer. Whether this is "good" or "bad" depends on a subjective evaluation of the risks, such as loss of tax benefits as well as the illiquidity of safe harbor lease investments.

2. Appendix A.—Seller Questionnaire

SUMMARY OF RESPONSES TO

SURVEY OF LESSEES (SELLERS)

IN SAFE HARBOR LEASE TRANSACTIONS

(Note that some questions were not answered by some respondents. Percentages are based on number of responses to each question.)

A. Taxpayer Profile

1. Principal business (see attached summary)

2. How old is the business?

	#	%
a. Less than five years old	2	7
b. Five to ten years old	2	7
c. More than ten years old	26	86

3. Do you consider your company to be a "start-up" business?

Yes	%	No	%
0	0	28	100

4. Are your shares publicly traded?

Yes	%	No	%
22	71	9	29

5. What is your tax year end? Most frequently occuring year-end 12/31.

6. Description of company size based on consolidated, worldwide figures from your financial statements (stated in millions).

	Under $25.0		$25-100		$101-500		$501-1,000		Over $1 Billion	
	#	%	#	%	#	%	#	%	#	%
a. 1981 Gross Revenues	3	10	7	23	7	23	1	3	13	41
b. 1981 Gross Assets	2	6	4	13	4	13	5	16	16	52
c. Pre-tax net income (before discontinued operations and extraordinary items)										
(1) 1981	17	59	3	10	9	31	-	0	-	0
(2) 1980	17	61	3	11	8	28	-	0	-	0
(3) 1979	14	50	3	11	11	39	-	0	-	0

7. Indicate your U.S. tax return liability (approximate in millions) for the following years:

	None		$0-5.0		$6.0 25.0		$26.0 100.0		Over $100 Million	
	#	%	#	%	#	%	#	%	#	%
a. 1981	14	52	7	26	5	18	1	4	-	0
b. 1980	13	50	8	31	2	8	3	11	-	0
c. 1979	9	35	11	42	3	12	2	8	1	3

8. How many persons do you employ (approximately):

	Total	Average
a. Worldwide?	438,409	14,142
b. In the United States?	387,229	12,491

9. How many of your employees (approximately) are presently laid off:

	Total	Average
a. Worldwide?	32,335	1,043
b. In the United States?	32,335	1,043

10. Indicate the total cost (excluding transactions fees) of all of the equipment and/or facilities which were the subject of safe harbor lease transactions in which you have been a participant.

Total
$2,316,694,439

Average Per Respondent
$76,556,481

B. General Information - Lessees (Sellers)

1. If you had not transferred investment credit ("ITC") in a safe harbor lease transaction(s), in which year(s) would you most likely have utilized the ITC involved on your U.S. tax return?

	#	%
a. In 1981	3	10
b. By 1982 or 1983	1	3
c. By 1984 - 1985	9	30
d. By 1986 - 1990	11	37
e. Not before 1991	6	20

2. Regarding the accelerated cost recovery system ("ACRS") deductions for the property involved in your safe harbor lease transaction(s), by which year do you estimate you would have had sufficient taxable income (on your U.S. tax return) so as to be ale to absorb those ACRS deductions?

	#	%
a. In 1981	8	26
b. By 1982 or 1983	2	6
c. By 1984 - 1985	7	23
d. By 1986 - 1990	10	32
e. Not before 1991	4	13

3. How did you determine the amount you wanted to receive for the "sale" of the tax benefits?

	#	%
a. Maximum amount offered (no matter how low)	15	50

	#	%
b. Based on present value analysis	15	50

4. If your response was b. in question 3, what after-tax discount rate did you assume in making the present value calculation?

Average
13.93%

5. Of what importance were each of the following factors in your decision to enter into your safe harbor lease transaction(s)?

	Not at all		Somewhat		Very	
	#	%	#	%	#	%
a. Inability to fully utilize additional ITC and/or obtain full benefit (i.e. at 46% marginal rate) from additional ACRS deductions	-	0	3	10	26	90
b. Future plans for capital investment	6	21	10	34	13	45
c. Immediate need for cash	11	38	5	17	13	45
d. Lack of other attractive sources of financing	17	59	5	17	7	24
e. Financial reporting effect	20	67	9	30	1	3

6. With regard to question 5.a., to what extent did each of the following factors contribute to your inability to utilize additional ITC or obtain full benefit from additinal ACRS deductions?

	Not at all		Somewhat		Very	
	#	%	#	%	#	%
a. Current operating losses from U.S. sources	10	33	4	13	16	54
b. Existence of net operating loss carryovers	21	72	2	7	6	21
c. Existence of investment credit carryovers	5	17	5	17	19	66
d. Existence of foreign tax credit carryovers	25	86	2	7	2	7
e. Alternative tax on net capital gains	27	93	2	7	-	0
f. Percentage depletion deductions	24	86	4	14	-	0

7. If the safe harbor lease rules had not existed, would you have leased some or all of the property anyway?

	#	%
a. Yes, definitely	1	3
b. Probably would have	3	10

c. Probably not	7	23
d. No, we had already purchased the property	18	58
e. No, "true leases" (i.e., under the rules before safe harbor leases) are too costly	2	6

8. If your answer to question 7 was a. or b., aproximately what percentage of the total equipment cost in this transaction:

a. Would have been leased, but not under a leveraged lease	Average 38%
b. Would have been leased under a leveraged lease	Average 25%

9. In 1981, what ratio did the proceeds, (i.e., cash downpayment by the "buyer") received from all safe harbor lease transactions in which you participated bear to the total capital expenditures you made for machinery/equipment and facilities? Average 15%

10. Did you revise (or do you plan to revise) your capital expenditures budget for 1981 - 1985 as a result of the enactment of the safe harbor lease rules?

Yes		No	
#	%	#	%
9	29	22	71

Why or why not? _____

_____

11. If the cash generated by the safe harbor lease transaction had not been available, what would have been your most likely source for the same amount of funds?

	#	%
a. Would not have needed those funds	6	19
b. Would not have had an alternative source	3	10
c. Would have borrowed the funds	16	52
d. Would have issued more stock	1	3
e. Would have liquidated other assets	4	13
f. Other	1	3

12. Do you plan to make use of the safe harbor lease rules in:

	Yes		No		Don't Know	
	#	%	#	%	#	%
a. 1982	27	88	2	6	2	6
b. 1983	21	68	4	13	6	19
c. Later	16	53	3	10	11	37

13. If you answered "yes to any year in question 12, what amount (i.e., cash downpayment) do you estimate will be

provided to you by the lessors in these safe harbor leases?

Years	1982	1983	Later
Amount (in millions)	Average	Average	Average
	40	[illegible]	46

14. Would repeal of the safe harbor lease provisions affect your investment decisions in the future?

Yes		No		Don't Know	
#	%	#	%	#	%
13	42	14	45	4	13

If "yes," briefly describe what effect such repeal would have _____

_____

If "no," briefly describe why not _____

_____

15. For each of the following statements, indicate whether you "Tend to agree," "Tend to disagree," or "Have no opinion."

If the safe harbor rules were repealed:

a. Our company would probably acquire (or merge with) a company in order to utilize expected unused tax credits and/or deductions.

	#	%		#	%		#	%
Agree	1	3	Disagree	28	90	No Opinion	2	7

b. There would be no change in our plans to acquire other companies.

	#	%		#	%		#	%
Agree	24	77	Disagree	3	10	No Opinion	4	13

c. Our company would probably be the target of a tax-paying company which wanted to use our expected excess tax credits and/or deductions.

	#	%		#	%		#	%
Agree	4	13	Disagree	22	71	No Opinion	5	16

d. There would be no change in the probability that our company would be acquired.

	#	%		#	%		#	%
Agree	25	81	Disagree	4	13	No Opinion	2	6

e. There would be little or no effect on the level of merger/acquisition activity in general.

	#	%		#	%		#	%
Agree	13	43	Disagree	11	37	No Opinion	6	20

f. There would be an increase in the level of merger/acquisition activity but our company would not be involved.

	#	%		#	%		#	%
Agree	11	35	Disagree	8	26	No Opinion	12	39

16. How would the repeal of the safe harbor lease provisions affect the volume of leveraged lease (or other true leases under prior law) you would enter into in the future?

	#	%
a. No effect	14	45
b. Increase a great deal	4	13
c. Increase somewhat	9	29
d. Decrease somewhat	4	13
e. Decrease a great deal	-	0

17. When you were considering and arranging the safe harbor lease transaction(s), were you aware of the possibility of transferring only the ITC to the "buyer" while retaining the ACRS deductions for yourself (the so-called "ITC strip lease")?

	#	%		#	%
Yes	30	97	No	1	3

18. Given the opportunity, would you have preferred to structure the safe harbor lease transaction as an "ITC strip lease" rather than a sale/leaseback?

	#	%		#	%
Yes	8	26	No	23	74

19. Was your ability to complete the safe harbor lease transaction(s) affected by the application of the "at-risk" rules to certain buyers and sellers?

Yes		No		Don't Know	
#	%	#	%	#	%
5	16	24	77	2	7

If so, in what way? _____

_____

20. Additional comments concerning safe harbor leasing

_____

_____

3. Appendix B.—Buyer Questionnaire

SUMMARY OF RESPONSES TO

SURVEY OF LESSORS (BUYERS)

IN SAFE HARBOR LEASE TRANSACTIONS

(Note that some questions were not answered by some respondents. Percentages are based on number of resposes to each question.)

A. Taxpayer Profile

1. Principal business (see attached summary)

2. How old is the business?

	#	%
a. Less than five years old	-	0
b. Five to ten years old	-	0
c. More than ten years old	10	100

	Yes	%	No	%
3. Are your shares publicly traded?	9	82	2	18

4. What is your tax year-end? Most frequently occuring year-end - 12/31.

5. Description of company size based on consolidated, world-wide figures from your financial statements (stated in millions).

	Under $25.0		$26-100		$101-500		$501-1,000		Over $1 Billion	
	#	%	#	%	#	%	#	%	#	%
a. 1981 Sales	3	27	2	18	1	9	-	0	5	46
b. 1981 Gross assets	3	27	-	0	3	27	-	0	5	46

6. Indicate your U.S. tax return liability (approximate in millions) for the following years:

	Under $5.0		$6-25		$26-100		$101-500		Over $500 Million	
	#	%	#	%	#	%	#	%	#	%
a. 1981	5	46	2	18	2	18	2	18	-	0
b. 1980	5	46	1	9	3	27	2	18	-	0
c. 1979	5	46	2	18	2	18	2	18	-	0

7. Indicate the <u>total</u> cost (excluding transaction fees) of <u>all</u> of the equipment and/or facilities which were the subject of safe harbor lease transactions in which you have been a participant.

Total	Average
$2,025,712,862	$184,155,714

B. <u>General Information - Lessors (Buyers)</u>

1. Regarding your decision to invest in the safe harbor transaction(s), how would you rank the following considerations in terms of their effect on your decision (e.g., 1, 2, 3)?

	1	%	2	%	3	%
a. Attractive yield on investment	8	80	1	10	1	10
b. Source of low cost funds for future needs	3	27	7	64	1	9
c. Financial reporting impact	0	0	2	20	8	80

2. a. Was your decision to invest in the safe harbor lease transaction(s) affected by the credit worthiness of the lessee?

Yes	%	No	%
10	91	1	9

b. Briefly describe why or why not. _____

_____

c. Were you indemnified by the lessee against the loss of tax benefits?

Yes	%	No	%
10	91	1	9

d. If so, what security did you require for the indemnification? (Check any that apply)

	#	%
(1) General credit of lessee	9	75
(2) Letter of credit	-	0
(3) Escrow of all of downpayment	-	0

(4)	Escrow of part of downpayment	-	0
(5)	Second mortgage	-	0
(6)	Security bond by an insurer	-	0
(7)	Other	# 3	% 25

e. Did the credit worthiness of the lessee affect the amount you were willing to pay the lessee for the tax benefits?

Yes	%	No	%
6	56	5	44

If so, in what way? _____

_____

3. In the absence of the safe harbor leasing rules, which of the following alternatives would have been the most likely use for the funds which you paid to lessees?

		#	%
a.	Short-term money market	5	46
b.	Marketable securities	1	9
c.	Municipal bonds	1	9
d.	Capital Expenditures	-	0
e.	Other	4	36

4. Did you revise (or do you plan to revise) your capital expenditures budget for 1981-1985 as a result of the enactment of the safe harbor lease rules?

Yes	%	No	%
3	27	8	73

Why or why not? _____

_____

5. In determining the amount of the cash down payment which you made, did you:

   a. Use the net present value method to analyze the transactions?

Yes	%	No	%
6	60	4	40

   If so, what after-tax discount rate did you assume?

Average
18%

   b. Use the sinking fund method to analyze the transaction?

Yes	%	No	%
9	82	2	18

   If so, what after-tax reinvestment rate did you assume for the sinking fund?

Average
5%

   c. Use the terminal value rate of return method to analyze the transactions?

Yes	%	No	%
1	11	8	89

If so, what after-tax reinvestment rate did you assume?

Average
8%

d. Use another method to analyze the transaction?

Yes	%	No	%
3	30	7	70

If so, briefly describe: _____

_____

6. For each of the following statements, indicate whether you "Tend to agree," "Tend to disagree," or "Have no opinion."

If the safe harbor lease rules were repealed:

a. Our company would probably acquire (or merge with) a company in order to utilize its expected unused tax credits and/or deductions.

	#	%		#	%		#	%
Agree	-	0	Disagree	11	100	No Opinion	-	0

b. There would be no change in our plans to acquire other companies.

	#	%		#	%		#	%
Agree	11	100	Disagree	-	0	No Opinion	-	0

c. Our company would probably be the target of a company which wanted to utilize its expected excess tax credits and/or deductions.

	#	%		#	%		#	%
Agree	1	9	Disagree	10	91	No Opinion	-	0

d. There would be no change in the probability that our company would be acquired.

	#	%		#	%		#	%
Agree	11	100	Disagree	-	0	No Opinion	-	0

e. There would be little or no effect on the level of merger/acquisition activity in general.

	#	%		#	%		#	%
Agree	8	73	Disagree	1	9	No Opinion	2	18

f. There would be an increase in the level of merger/acquisition activity but our company would not be involved.

	#	%		#	%		#	%
Agree	4	36	Disagree	4	36	No Opinion	3	18

7. By what percent (approximate) were you able to reduce your 1981 U.S. tax return liability as a result of entering into safe harbor lease transactions?

Average
41%

8. Additional comments regarding safe harbor leasing.

_____

_____

_____

_____

4. Appendix C.—Pricing Analysis-Seller

ANALYSIS OF TRANSACTION PRICING FROM STANDPOINT OF SELLER

From the standpoint of the user of property, (i.e., the seller in a safe harbor lease transaction structured as a "wash lease"), the object of entering into the transaction is the realization of the tax benefits associated with the property. Without safe harbor leasing, or some other approach designed to transfer tax benefits to another, the value of the benefits depends upon the user's ability to reduce its U.S. income tax liability by means of investment tax credit (ITC) and cost recovery deductions (ACRS deductions). Since ACRS tax benefits are normally realized over a period of time, they must be appropriately discounted in order to reflect their "present value" to the user.

A user who is considering a safe harbor lease transaction because of its inability, for one reason or another, to realize tax benefits currently or in the near-term future would want to obtain benefits (preferably cash) in an amount as near as possible to the present value of the benefits associated with ownership of the property. To the extent the amount realized by a user under a safe harbor lease transaction approaches the present value of the tax benefits of ownership, the transaction can be described as "efficient".

Our analysis attempts to measure the efficiency of safe harbor leasing from the seller's standpoint based on information obtained in the survey. To perform this analysis a number of

assumptions are required. Those assumptions are identified below, along with explanatory comments that we believe necessary and helpful.

The benefits obtained in lieu of tax benefits of ownership by a seller in a safe harbor lease structured as a "wash lease" are: (1) a cash downpayment from the buyer; (2) net rental deductions over the lease term equal to the difference between the cost or basis of the property and the downpayment received; and (3) the ability to control or retain the property at the end of the lease term at no additional cost. It should be noted that this latter benefit is normally present for property which the user owns. It is not present (i.e., there is an additional cost to the user), in the case of property leased under prior law. In those leases, the user ordinarily was required to pay fair market value or some approximation thereof in order to retain the property after the lease term. This benefit or cost is not reflected in our analysis since it varies dramatically according to the type of property involved. Our analysis is directed to the efficiency of safe harbor leases vis-a-vis property ownership and does not attempt to compare it to "true leasing".

The present value, then, of the cash downpayments and future tax deductions available to the seller were determined for representative safe harbor leases of five-year and ten-year terms. The assumptions included in these representative leases are listed below.

Assumptions	Explanation
1. ACRS Class - 5-year	- Most frequent in survey
2. ITC Rate - 10%	- Most frequent in survey
3. Date placed in service - November 1981	- Most frequent in survey
4. Term of lease - 5-year and 10-year	- Most frequent in survey
5. Down payment as a percentage of equipment cost - 5-year lease A. 17.96% B. 18.61%	- A. The average (mean) downpayment received by sellers in leases of the same duration for which information was provided.
- 10-year lease A. 25.17% B. 24.18%	- B. The average downpayment (weighted to reflect equipment cost in actual transactions) received by sellers in leases of the same duration for which information was provided.
6. Terms of note to seller - length - same as lease term - payments - level payment - interest rate - 12%	 - Most frequent in survey - Most frequent in survey - Interest rate under IRC Section 6621; i.e., reasonable rate pursuant to Temp. Regs.
7. Rental payments - level; equal to payments on note to seller	- Most frequent in survey
8. Discount rate - 13.93%	- Average (mean) rate used by sellers in evaluating safe harbor lease transactions, according to responses in survey (Question B4)
9. Tax benefits realized at end of tax year (12/31).	- Conservative assumption since buyers may receive benefits earlier.

A 5-year safe harbor lease transaction with these parameters with a down payment as in 5.B above, and involving property costing $1,000,000 would result in certain cash flows to the seller, assuming a 46% Federal tax rate and assuming the deductions could be utilized currently.

Cash Flows of Seller -
5-Year Safe Harbor Lease Transaction

	Taxable (Loss)	Tax Benefit	Down Payment	Cash Flow
1981	$ (20,026)	$ 9,212	$186,100	195,312
1982	(128,930)	59,308	-	59,308
1983	(145,282)	66,830	-	66,830
1984	(163,710)	75,306	-	75,306
1985	(184,474)	84,858	-	84,858
1986	(171,478)	78,880	-	78,880
	$(813,900)	$374,394	$186,100	$560,494

The present value of annual cash flows as shown above, when discounted at 13.93% is $436,650.

The maximum present value of the tax benefits of ownership, (i.e., ITC and ACRS deductions), i.e., assuming current utilization, and discounted at 13.93% is $446,723, determined as follows:

	Tax Benefit of ACRS Deductions	ITC	Cash Flow
1981	$ 69,000	$100,000	$169,000
1982	101,200	-	101,200
1983	96,600	-	96,600
1984	96,600	-	96,600
1985	96,600	-	96,600
	$460,000	$100,000	$560,000

The present value of these cash flows, when discounted at 13.93%, is $446,723.

The foregoing would indicate that, generally speaking, safe-harbor leasing enables sellers (i.e. users of property) to realize 97.75%, ($436,650 ÷ $446,723 = 97.75%), of the maximum present value of the tax benefits associated with the ownership of equipment. The following table summarizes the results of our analysis for all four leasing structures.

PERCENTAGE OF BUYER'S TAX BENEFITS REALIZED BY SELLERS IN REPRESENTATIVE LEASES

	Present Value* of Safe Harbor Lease Cash Flows	Present* Value of Ownership of equipment	Percentage of Tax Benefits Realized by Seller
5-year lease			
A. Average downpayment	$432,138	$446,723	96.74%
B. Weighted average downpayment	$436,650	$446,723	97.75%
10-year lease			
A. Average downpayment	$407,928	$446,723	91.32%
B. Weighted-average downpayment	$400,097	$446,723	89.56%

* Cash flow discounted at 13.93%

The above table would seem to indicate that, on the whole, buyers paid the sellers nearly all of the present value of the tax benefits available under ACRS. Commissions and fees paid by buyers to third parties would have reduced the downpayment made to the seller; therefore, a portion of the cost of the transaction is already reflected in the above table. Additional fees paid, or costs incurred, by the sellers, if any, would reduce the present value of the safe harbor lease transaction.

Finally, and perhaps most importantly, the above analysis assumed that the user of the property could utilize tax benefits currently. Realistically, one who is seriously

considering transferring tax benefits does so due to an inability to utilize tax benefits currently (as was confirmed by this survey). Therefore, the present value of the tax benefits is less than the maximum as depicted above. To the extent that one would have waited until later, for example three or four years, to utilize available tax benefits, the efficiency of safe harbor leasing increases. This is due to the fact that the seller receives a cash downpayment and does not rely totally on the ability to utilize tax deductions in order to realize the value of the benefits. Under these circumstances, a seller could receive benefits through safe harbor leasing in excess of the present value to it of the tax benefits of ownership of property.

5. APPENDIX D.—PRICING ANALYSIS-BUYER

ANALYSIS OF TRANSACTION PRICING
FROM STANDPOINT OF BUYER

The majority of transactions characterized as leases for federal income tax purposes under the safe harbor leasing rules have been structured as "wash-leases." Under this structure, the buyer typically has no interest in the actual property nor in the residual value of the property after the lease term. The buyer's sole interest in the transaction is to obtain the investment tax credit (ITC) and accelerated cost recovery deductions (ACRS deductions) associated with the property. In a wash-lease, the buyer makes an initial investment, or cash downpayment, and has no further net cash flow other than as a result of the tax impact of the transaction.

By determining the amount of the initial downpayment, the buyer can project with relative certainty (other than the possibility of an early termination or disqualification of the transaction) the after-tax cash flows that will result. Because the ACRS deductions are accelerated and due to the ITC, the typical lease results in tax savings (positive cash flow) to the buyer in the early years of the lease followed by tax payments (negative cash flow) in later years. The sum of these tax savings and payments, when combined with the initial investment, is ordinarily negative. That is, the safe harbor lease transaction, on its face, appears to be a loss transaction.

The transaction can be profitable (and, of course, one would expect all buyers to strive for profitable investments) if

the positive cash flows can be realized quickly and reinvested so as to achieve additional positive cash flows or "secondary earnings," as they are sometimes called, in the early years of the transaction. Although there are many variables to be considered (not the least of which is the possible loss of tax benefits due to early disqualification referred to above), the primary factors which influence the buyer's investment yield are: (1) the amount of the initial downpayment and the term of the lease; (2) the timing of the realization of the tax benefits, and (3) the assumed reinvestment rate, i.e., the rate at which the cash generated by tax deferrals can be reinvested.

Once the variables have been determined (or assumed), there are various methods to analyze the anticipated after tax cash flows. We have analyzed several representative safe harbor lease transactions using the terminal value rate of return method. The leases analyzed and their assumptions are the same as those used in Appendix C. That is, the leases had five and ten year lease terms and the assumed downpayments were the average and weighted-average downpayments (weighted to reflect the volume of equipment cost in the transaction), which were actually paid to the sellers in transactions reported to us. The downpayment was made at lease commencement (November 13, 1981), and the buyer was assumed to be a calendar year taxpayer and to realize 50% of the first year's tax benefits in its December, 1981 estimated tax payment. The balance of the first year's tax benefits as well as all future tax benefits were assumed to occur so as to maximize the benefit to the buyer.

Finally, our analysis was made using three different after-tax reinvestment rates -- 6%, 8% and 10%. That is, the buyer was assumed to be able to reinvest the positive cash flows from tax savings at these rates. The terminal value rate of return based on the resulting after-tax cash flows was then determined. This value, which is in effect the composite yield for the investment itself and the yield from reinvesting the funds, can then be compared with the yields of other alternative investment opportunities in order to evaluate whether the safe harbor lease transaction is "favorable." For example, the yield can be compared with the after-tax yield of corporate bonds, U.S. government obligations or tax-exempt municipal bonds. In doing so, one must, of course, consider other factors such as risk of loss (both of capital and income) and the liquidity of the investment.

Our analysis indicated the following terminal value rates of return for the representative leases of five-year and ten-year duration:

Buyer's After-tax Reinvestment Rate	Terminal Value Rates of Return for Leases With Various Downpayments			
	5-Year Lease		10-Year Lease	
	A	B	C	D
6%	6.95%	6.55%	6.50%	6.77%
8%	9.08%	8.66%	8.84%	9.12%
10%	11.17%	10.75%	11.08%	11.37%

Note: Downpayments assumed, expressed as a percent of equipment cost, are:

A - 17.96%
B - 18.61%
C - 25.17%
D - 24.18%

The above table indicates that the yield to buyers in safe harbor leases which are representative of those actually completed exceeds the reinvestment rate, or the break-even rate, by about one percentage point. For example, if the after-tax reinvestment rate in a five-year lease, in which the downpayment equaled 18.61% of equipment cost, was 10%, the terminal value rate of return would be 10.75%, i.e., less than one percentage point greater. A buyer would presumably be indifferent to investing in a transaction with a yield equal to the assumed reinvestment rate. Only where yields are greater than the assumed rate would they be more attractive than other investment opportunities with similar risks.

To provide the reader with some examples of the yields available on some other investment alternatives, we have included information concerning yields on various bonds. Yields on bonds

other than municipal bonds must be reduced by 46% in order to reflect an after-tax yield, as does the table above regarding terminal value rates of return. The source of the following information is Standard & Poor's Corporate & Government Bond Yield Index for the week of November 11, 1981:

	Average Yields
Corporate Bond - Composite (AAA Rating)	13.78%
Corporate Bond - Composite (BBB Rating)	15.40%
U. S. Government Bond - Long Term	13.25%
U. S. Government Bond - Intermediate	12.97%
Municipal Bond	10.98%

Chairman ROSTENKOWSKI. Mr. Dickey, you may proceed.

STATEMENT OF CHARLES D. DICKEY, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SCOTT PAPER CO.

Mr. DICKEY. Thank you, Mr. Chairman.

I have submitted a written statement, which I would like incorporated in the record.

Scott Paper Co. is testifying today in support of the safe harbor leasing provisions incorporated in the Economic Recovery Tax Act of 1981. Safe harbor leasing is the only provision of last year's tax bill that has had any meaningful impact on our company. Furthermore, we know of no other legislation of greater importance to many of America's capital-intensive industries.

In the past year, we have embarked on the most aggressive capital spending plan in our company's history. Scott plans to spend $1.6 billion over 5 years to expand capacity, to modernize our plants, to increase productivity, and to reduce our dependence on foreign oil. Capital spending for 1982 will be almost half a billion dollars, up more than 40 percent over the last year, and 80 percent over 1980. This capital program, which provides thousands of construction jobs alone, is the largest and most important project we have ever undertaken. Our capital spending plans rely directly on safe harbor leasing. Either its repeal or a modification which would preclude our ability to participate in safe harbor lease transactions would force indefinite postponement or cancellation of large parts of our capital plan equalling several hundred million dollars.

Scott Paper Co., along with many other major firms in our industry, has been an active seller in the leasing market. In 1981, we entered into several transactions involving millions of dollars of capital equipment in 14 States, and received about $50 million in badly needed cash. The cash we received was immediately used to finance more projects. We have expected to participate in further transactions in 1982 and 1983 in the same magnitude.

There are two basic facts which must be understood if one is to have a full appreciation of safe harbor leasing. First, safe harbor leasing is nothing more than a financing mechanism. It provides companies like ours with the tax benefits we have earned as a result of capital spending. Second, safe harbor leasing is an essential element of equity in the accelerated cost recovery system.

Without safe harbor leasing, Scott Paper Co. and many other capital-intensive firms would have received no direct benefit and would be at an even greater competitive disadvantage as a result of the accelerated depreciation bill passed last year. To underscore this point, we computed the benefit of the "10-5-3" proposal. Over a 5-year period, the accelerated depreciation proposal would have generated $250 million in additional deductions for Scott, while yielding less than $10 million in actual tax savings.

The reason is simple. Tax benefits generated from our capital program were exceeding our earnings capacity. From a competitive point of view, the accelerated depreciation proposal would have actually hurt us more than it helped. The leasing idea was born out of attempts to correct this problem, and it has worked very well in the sense that it has provided capital in an equal and efficient

manner. Scott Paper Co. is a perfect example of how well it is working.

One problem which has been particularly vexing, Mr. Chairman, has been the artificial suspension of the leasing markets since February 19. Because lease transactions are now extremely difficult to put together, there has been a sharp reduction in projected cash flow which threatens current capital projects.

Rather than turning incentives on and off, a consisent long-term tax policy encouraging capital formation is critical to the economic health of the country. I cannot overstate that point. The Federal Government's propensity to zigzag the tax laws frustrates capital formation and capital spending because it makes it impossible to plan ahead.

By providing important incentives to America's hard-pressed capital-intensive industries, safe harbor leasing is an effective force working against the recession. Any adjustments in safe harbor leasing should be postponed until the economy is restored to a healthy status.

We are anxious to work with the committee to eliminate any demonstrated abuses of the laws, but we urge the committee not to destroy this essential procapital formation and procapital spending law in the process.

In summary, it has been our experience that leasing has been working exactly the way it was intended to work. By encouraging us to continue our largest capital program ever, it has provided equal access to tax benefits earned by capital projects. Its repeal would have an immediate and very negative impact on our company. We urge the committee to give its full support to policies that provide these incentives to capital-intensive industries. The current economic recession serves to underscore the need for this equitable tax law.

[The prepared statement follows:]

STATEMENT OF CHARLES D. DICKEY, JR., CHAIRMAN OF THE BOARD, SCOTT PAPER CO.

Mr. Chairman and members of the committee, Scott Paper Company is testifying today in support of Section 168(f)(8) safe harbor leasing provisions incorporated in the Economic Recovery Tax Act of 1981. Safe harbor leasing is the only provision of last year's tax bill that has had any meaningful impact on Scott Paper. Furthermore, we know of no other legislation of greater importance to many of America's capital intensive industries than this and come before you to state our case and explain how safe harbor leasing is affecting our Company.

Scott Paper Company is one of America's oldest and best known pulp and paper companies. We employ 20,000 people directly and many more indirectly. In 1981 our total domestic sales equalled $2.3 billion. We make a wide variety of consumer and commercial paper products for the home, the office and industry as well as printing and publishing papers.

Within the past year we have embarked on the most aggressive capital spending plan in our Company's history. Scott plans to spend $1.6 billion over five years to expand capacity, modernize our plants, increase productivity and reduce our dependence on foreign oil. Capital spending for 1982 will be almost half a billion dollars, up more than 40 percent over last year and 80 percent over 1980. This capital program, which provides thousands of construction jobs alone, is the largest and most important project we have ever undertaken.

Both the magnitude and timing of our capital spending plan are related directly to safe harbor leasing. Either the repeal or a modification which would preclude our ability to participate in safe harbor lease transactions would force decisions to postpone indefinitely or cancel large parts of our capital plan equalling several hundred million dollars.

Scott Paper Company, along with many other major firms in our industry, has been an active seller or lessee in the leasing market. In 1981 we entered into several transactions involving millions of dollars of capital equipment in fourteen states[1] and received about $50 million in badly needed cash. The cash we received was immediately used to finance more projects. We have expected to participate in further transactions in 1982 and 1983 in the same magnitude. Importantly, the funds we plan to receive are an essential ingredient in financing our capital projects this year and next.

There are two basic facts which must be understood if one is to have a full appreciation of safe harbor leasing:

First—Safe harbor leasing is nothing more than a financing mechanism. It provides companies like ours with the tax benefits we have earned as a result of capital spending. It is far superior to the old leveraged leasing rules and very efficient. It also tends to equalize access to tax benefits and incentives for all. If the safe harbor leasing law were not in existence, we would be denied access to our earned tax benefits.

Second—Safe harbor leasing is an integral and absolutely necessary part of the Accelerated Cost Recovery System (ACRS). Without safe harbor leasing, Scott Paper and many other capital intensive firms would have received no direct benefit and would be at an even greater competitive disadvantage as a result of the accelerated depreciation bill passed last year. To underscore this point, we computed the benefit of the "10-5-3" proposal. We determined that over a five-year period the accelerated depreciation proposal would have generated $250 million in additional deductions for Scott, while yielding less than $10 million in tax savings. The reason is simple: tax benefits generated from our capital program were exceeding our earnings capacity. From a competitive point of view, the accelerated depreciation proposal would have actually hurt us more than it helped. Compounding the whole problem was almost $50 million in Investment Tax Credits we could not use and were carrying forward. The leasing idea was born out of attempts to correct this problem and it has worked very well.

Let us all remember that the guiding purpose in passing this tax legislation was to spur capital formation and capital spending. Although the recession and high interest rates have combined to limit capital spending, the legislation is correct and it is working. The most serious mistake we could make now would be to repeal leasing. Scott Paper Company is a perfect example of how well it is working.

The Treasury Department, the Congressional Budget Office, economic advisors in both the Carter and Reagan Administration and many outside experts all agree that this leasing provision makes sense, especially in conjunction with ACRS. If it is repealed now, or if it is unreasonably modified, it will have severe consequences.

In any objective look at leasing, Congress must review the positive benefits and incentives it provides in terms of encouraging capital spending. Here are several factors to consider:

1. The greatest benefit is provided to the seller or lessee and not the buyer. The seller is the company who earned the benefit by undertaking capital projects. On the present value basis, sellers receive between 85¢ and 95¢ on the dollar for tax benefits transferred.

2. Safe harbor leasing acts to discourage tax-motivated corporate acquisitions and takeovers. As an example, Scott Paper could be a prime candidate for takeover by a major oil company, not only because of our land holdings, but also because of large accrued, but not used, tax benefits. In other words, without leasing, Scott would unwillingly be financing our own hostile takeover.

3. A review of the sellers will show that generally the competitive industries that are aided the most by safe harbor lease transactions are America's basic industries and those that are the most capital intensive with low returns on investment.

4. Safe harbor leasing promotes tax neutrality. It gives all companies equal access to tax incentives they have earned.

Scott Paper recognizes that there has been controversy concerning this law, and we are rather painfully aware that the market for lease transactions, so critical to our cash flow and 1982 capital plan, virtually evaporated after February 19, 1982. While both of these situations are most regrettable, they are also correctable. We cannot deal with the artificial suspension of the market, but we are prepared to offer some constructive suggestions regarding the controversy.

The safe harbor leasing law is complicated as are many other financing tools. Initial press reports that sought to explain the basis for the law were incomplete, one-

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[1] Pennsylvania, Georgia, Delaware, Washington, New York, Indiana, Mississippi, New Jersey, Wisconsin, Alabama, Maine, Arkansas, California, Texas.

sided, misleading and apparently written more for their sensational value than to inform the public.

Nonetheless, there are, admittedly, several perception problems. Each, I believe, can be dealt with without destroying the inherent fairness and value of the tax law.

One perceptual problem, disputed I might add by the Treasury Department, is that small businesses and new start-up businesses have not fully benefitted from the law. We believe that there are no major barriers that preclude participation by small and start-up businesses and that the market is quickly adjusting to make these transactions possible. However, if it is essential to make further changes, these can be dealt with easily in several ways, either by opening up the law to permit closely held corporations to participate and/or by allowing any business to enter into at least $5 million in lease transactions without restriction.

A second perceptual problem is that some large and rich companies may be buying tax benefits to such a degree that they virtually eliminate much of their tax liability to the federal government. There are several ways to solve that problem as well. The best way is to put a cap on the amount of tax benefits a company can purchase. This can be accomplished by prohibiting the purchase of tax benefits that reduce the buyers tax liability by more than a specified percentage.

An acknowledged third problem is the projected federal deficit. The Treasury Department estimates the revenue impact of safe harbor leasing in 1982 to be approximately $3 billion. That could be trimmed by a variety of techniques, but doing so would have most unsatisfactory consequences for the economy. It would cause the cancellation of capital projects and eliminate jobs associated with those projects. It would increase social support costs; and, it would reduce revenue opportunities for the government. By providing important incentives to America's distressed capital intensive industries, safe harbor leasing is an effective working force against the recession. Any adjustments in safe harbor leasing that would reduce capital investment should be postponed until the economy is restored to a healthy status.

We are anxious to work with the committee to eliminate perceived abuses of the law, but we urge the committee not to destroy this essential pro-capital formation and pro-capital spending law in the process.

There are some in the business community who have called for repeal or modification of safe harbor leasing. We believe that it is important for the committee to evaluate their motivation.

Some in Congress have called for a review of leasing. We welcome a review because we know of no other federal tax policy for business working so well, so quickly for America's distressed, capital intensive industries.

In summary, it has been our experience that leasing has been working exactly the way it was intended to work for distressed industries. It has encouraged us to continue our largest capital program ever. It has provided equal access to tax benefits earned by capital projects. Its repeal would have an immediate and very negative impact on our Company. We urge the Committee to give its full support to policies that provide these incentives to capital intensive industries. The current economic recession serves to underscore the need for this equitable tax law.

Mr. DICKEY. Now, I would like to introduce Mr. Jaicks, of Inland Steel.

STATEMENT OF FREDERICK G. JAICKS, CHAIRMAN, INLAND STEEL CO.

Mr. JAICKS. Thank you.

Mr. Chairman, members of the Ways and Means Committee, I appreciate the opportunity of appearing before you this morning.

I am Fred Jaicks, chairman of Inland Steel Co., and with your permission, just a short profile of Inland. We are a Chicago-based integrated steel producer employing approximately 35,000 men and women. We are the seventh largest steel producer, but we do operate the largest individual steel plant in the United States in East Chicago, Ind. For many years, we have had one of the best profitability records in the industry, and we have recorded profits every year since 1932.

However, we, along with the majority of the domestic steel companies, have been weakened recently by some severe foreign trade

problems, by enormous environmental control costs, and more recently by 2 years of depressed steel demand. In our case, we actually reported a loss in the fourth quarter of 1981, and may be faced with that situation again this first quarter. I guess that places us in a distressed industry, in a distressed period.

My purpose this morning is to explain the practical importance of the safe harbor leasing provision to Inland and the steel industry. To return to acceptable levels of profitability and reliable employment, to improve our competitive posture vis-a-vis foreign competition, it is imperative that this industry move forward in a program of modernization. This is most difficult during a period of profit squeeze with its inherent limitation on internally generated funds and restrictions on the amounts we can prudently borrow.

The dollars to accomplish this in steel are big. In Inland's case, the first phase of a major modernization program commenced in 1974 and was completed in 1980 at a cost of over $1 billion. The second phase of this program, as originally laid out, would have involved almost as much money as the first phase, and would have provided new coke oven batteries, a major new finishing facility, and increased continuous casting capability.

However, with the recession in the steel business which commenced in 1980 and which is still with us, we were forced to conclude that this expansion and modernization should be substantially cut back, at least for the present. Thus, in 1981, our capital expenditure program was restrained and held to approximately $135 million. It was $240 million in 1980. And similar restraints are being exercised in 1982.

The steel industry generally has similar massive requirements for modernization expenditures. Since November 1980, individual steel companies in the United States have announced modernization programs totaling $7 billion in capital investments, greater than any amount for a comparable period since World War II. The struggle that will be required to justify and finance expenditures of this magnitude under today's operating conditions is obvious.

Inland and the steel industry vigorously supported the Economic Tax Recovery Act of 1981, particularly the ACRS incentive systems, in the belief that it would aid savings and investment. But without the safe harbor leasing provisions, steel companies and other capital-intensive businesses would be unable to use much of the investment incentives which Congress provided because taxable profits from existing assets are insufficient to absorb the incentives generated by new assets.

Inland's profits have simply not been large enough to absorb the investment credits generated by its huge prior investment programs. The combination of low-operating profits for 1980 and 1981 and the incentive depreciation deductions allowed for tax purposes produced net operating losses for tax purposes.

Even with an upswing in business, safe harbor leasing will still be important to our industry. Congress has designed the tax incentives in such a way that the usability depends upon the ratio of new investments to taxable income. Companies with large amounts of new investments, which generally include capital-intensive industries, companies like steel, are likely to have a continuing need. Given the capital-intensive nature of the steel business and the

massive modernization expenditures that need to be made, we project that even with more normal profit levels and a more robust economy, it will be a number of years before all of the tax incentives we generate can be absorbed currently.

The discontinuance of ACRS investment credit incentives through safe harbor leasing or some other comparable mechanism would have two similar but distinct adverse effects. First, the inability to use the incentive credits restricts the funds that can be made available to finance new investment. We simply cannot build facilities for which we do not have the money, and there is a serious shortage for many steel companies today.

We can see in the marketplace that in the aggregate, the incentive tax benefits provided by law may supply cash equivalent to 30 percent or more of the cost of the asset. If the incentives are available, we obviously can do much more than if they are not.

Second, inability to use the incentives increases our effective capital costs in comparison to others, which makes us and our products less competitive, further squeezing our profits. For example, in 1981, when it became clear that Inland would not be able to absorb its unused tax incentives currently, we calculated that Inland's net capital costs for new facilities would be 30 to 40 percent higher than the net cost of similar facilities for a company that could use the incentives.

With higher costs, our profits will obviously be less, and that prospect is an obvious deterrent to new investment. By entering into a safe harbor lease, we calculated we could eliminate 70 to 80 percent of this excess capital cost, leaving us with not all but most all of the incentives provided by Congress to more profitable companies.

Accordingly, we placed about $70 million of our 1981 additions in a safe harbor lease and received over $19 million in cash. We were planning similar transactions in 1982 involving larger amounts of property until the February 19 cutoff proposal, which made everything uncertain, and we were forced to delay our plans.

In summary, Mr. Chairman, restrictions on safe harbor leasing would in my view force steel companies that cannot directly use tax incentives available to other companies to scale back important portions of their vital modernization programs at a high cost in terms of the Nation's industrial strength and employment and competitivenes. We do not feel we are asking for special favors. We simply ask that steel and other capital-intensive industries in steel's position share the same investment incentives that Congress has provided for companies that happen to have taxable income. That will permit companies like Inland to compete equitably for investment funds, and to continue to contribute to America's economic vitality.

I would like to next call on Mr. Tippett, chairman of the American Motors Corp.

[The prepared statement follows:]

STATEMENT OF FREDERICK G. JAICKS, CHAIRMAN, INLAND STEEL CO., CHICAGO, ILL.

My name is Frederick G. Jaicks and I am Chairman of the Board of Inland Steel Company, an integrated steel business, headquartered in Chicago. Inland employs approximately 35,000 men and women and, in raw steel production, it is the seventh

largest steel company in the United States. It has, for many years, been among the most profitable of the steel companies. It has reported profits every year since 1932.

Notwithstanding the fact that we have consistently reported profits, our profits today are inadequate. In fact, we actually reported a loss in the fourth quarter of 1981, and may be faced with that situation again in the first quarter of 1982.

Today's profits squeeze is the combined result of the state of the economy, the particularly depressed condition of several of our major customers, including the automobile manufacturers, and the impact of imported steel. We are clearly in a distressed industry during a distressed period.

My purpose today is to explain the practical importance of the safe harbor leasing provisions to Inland, and to the steel industry generally, in the context of today's economic situation.

In order to return to acceptable levels of profitability and employment, Inland and the industry need to move forward with a program of continuous modernization in order to meet changing conditions, and to take advantage of the efficiencies provided by technological advances. This is, of course, very difficult during a period of profits squeeze, with its inherent limitations on internally generated funds, and restrictions on the amounts that we can prudently borrow.

Very large dollar investments are at stake. In Inland's case, the first phase of a major modernization program commenced in 1974, and was completed in 1980 at a cost of over $1 billion. The second phase of the program, as originally laid out, would have involved almost as much money as the first phase, and would have provided new coke oven batteries, a major new finishing facility and increased continuous casting capacity. However, with the recession in the steel business, which commenced in 1980 and which, after a brief upturn, returned and is still with us, we were forced to conclude that this expansion and modernization should be substantially cut back, at least for the present.

Thus, in 1981, our capital expenditure program was restrained and held to approximately $135 million. Similar restraints are being exercised in 1982.

The steel industry in general has similar massive requirements for modernization expenditures. Since November, 1980, individual steel companies have announced modernization programs totaling more than $6.9 billion in capital investments. The struggle that will be required to justify and finance expenditures of this magnitude under today's operating conditions is obvious.

Inland and the steel industry vigorously supported the Economic Tax Recovery Act of 1981, particularly the ACRS incentive system, in the belief that it would aid saving and investment. But without the safe harbor leasing provisions, steel companies and other capital intensive businesses would be unable to use much of the investment incentives which Congress has provided because taxable profits from existing assets are insufficient to absorb the incentives generated by new assets.

Although Inland has been profitable in its financial statement, Inland's profits have not been large enough to absorb the investment credits generated by its prior huge investment programs. The combination of low operating profits for 1980 and 1981 and the incentive depreciation deductions produced net operating losses for tax purposes.

I do not want to leave the impression that the need for safe harbor leasing is only a recession phenomenon that will disappear with upswings in the business cycle. Congress has designed the tax incentives in such a way that their usability depends upon the ratio of new investments to taxable income. Companies with large amounts of new investments, which generally include capital intensive companies like steel, are likely to have a chronic problem. Given the capital intensive nature of the steel business and the massive modernization expenditures that need to be made, Inland projects that, even with more normal profit levels and a more robust economy, it will be a number of years before all the tax incentives Inland generates can be absorbed currently.

If the ACRS and investment credit incentives are not available to Inland through safe harbor leasing or some other comparable mechanism, Inland's investment program will be impacted adversely in a major degree. The unavailability of the incentives has two similar, but distinct effects:

First, inability to use the incentives restricts the funds which can be made available to finance new investment. We cannot build facilities for which we do not have the money. Financing constraints are serious for many steel companies today, and are obviously accentuated by the recession. For companies with taxable income, the tax incentives provide an important cash flow. If we also owned a profitable unrelated company, for example, the investment credit alone would immediately provide 10% of the cost of a new steel facility. We can see in the market place that, in the aggregate, the incentive tax benefits provided by the new law may supply cash

equal to 30% or more of the cost of the asset. If the incentives are available, we can obviously do much more than if they are not available.

Second, inability to use the incentives increases our effective capital costs in comparison with others, which makes us and our products less competitive, further squeezing our profits. For example, in 1981, when it became clear that Inland would not be able to currently absorb its unused tax incentives, Inland's financial staff calculated that Inland's net capital cost for new facilities would be 30 to 40 percent higher than the net capital cost of similar facilities to a company that could use the incentives currently. If our costs are higher, our profits will obviously be less; and that prospect is an obvious deterrent to new investment. By entering into a safe harbor lease, we calculated we could eliminate 70 to 80 percent of this excess capital cost, leaving us with not all, but most all, of the incentives provided by Congress to more profitable companies. Accordingly, Inland placed about $71 million of its 1981 additions in a safe harbor lease, and received approximately $19,600,000 in cash. We were planning similar transactions in 1982, involving larger amounts of property. However, the announcement that the safe harbor leasing rules might be altered for transactions entered into after February 19, 1982, made everything uncertain, and we were forced to delay our plans. That, obviously, does not contribute to economic recovery, but we had little choice.

It is relevant, I think, to relate one other fact about our 1982 capital investment program. One of the major facilities under construction is a new continuous annealing line, which will provide lightweight, high strength steel for the automotive industry. It will cost about $100 million. Several years lead time is often involved in constructing major facilities of this kind, and planning for this facility commenced in 1980—before safe harbor leasing. By then, it was apparent that we might be unable to use the tax incentives provided. Under the circumstances, we made plans to use a traditional "leveraged lease." That lease would have transferred the tax benefits of the asset to the lessor in return for a reduction in the rentals Inland would pay. Our financial people say that such leveraged leases have been a common transaction for many years. They perform the same tax benefit transfer function as a safe harbor lease. The same incentives are transferred to a lessor, but under the old rules, the lessor would not be permitted to pass as much of the incentive back to Inland as under a safe harbor lease.

After the safe harbor legislation, we restructured the transaction. As restructured, we will still have a "leveraged lease." The lessor will purchase the asset partly with its own funds and partly with funds borrowed from a third party, rather than from Inland. But the lease will also qualify under the safe harbor rules, if they remain unchanged.

The point is that the principles of safe harbor leasing are not new, but have been with us for many years. In the case of the continuous annealing facility, cutting back the safe harbor provisions would not reduce the amount of incentives used, as the same amount of deductions and credits could be transferred under the old leveraged lease rules. It would simply reduce the amount of those incentives which would go to the lessor and be passed back to Inland.

In summary, restrictions of safe harbor leasing would, in my view, force steel companies that cannot directly use tax incentives available to other companies to scale back important portions of their vital modernization programs. The cost, in terms of the nation's industrial strength and employment, particularly during a recession, would be substantial.

In urging the retention of safe harbor leasing, we are not asking for special favors. We simply ask that steel, and other capital intensive industries in steel's position, share in the same investment incentives that Congress has provided for companies that happen to have taxable income. This will permit companies like Inland to compete equitably for investment funds, and to continue to contribute to America's economic vitality.

STATEMENT OF W. PAUL TIPPETT, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICAN MOTORS CORP.

Mr. TIPPETT. Good morning, Mr. Chairman. My name is Paul Tippett. I am chairman and chief executive officer of American Motors Corp.

In addition to my oral remarks we are submitting a more detailed statement which I would ask be included in the record of these hearings.

For your background, in 1981 American Motors sold over 300,000 vehicles worldwide. Our total sales were about $2.5 billion, and this year will be about $3.5 billion. We have worldwide 10 vehicle assembly plants and 14 major component plants. Our corporate employment is about 21,000, and the corporate payroll last year was $744 million. In addition, our franchise dealers have another 26,000 employees. We are the 42d largest exporter in the country, and contributed almost $200 million to a favorable balance of payments position as far as we are concerned.

American Motors is a good example of a company that is strengthened by safe harbor. For instance, in 1981, AMC received $10 million by selling the tax benefits associated with a new $30 million paint facility at its Jeep plant in Toledo, Ohio. This $10 million is now being invested in other job-producing projects. Repeal of the safe harbor provision would be a disaster for American Motors and other basic industries in this country. The capital to be derived from safe harbor leasing transactions of 1982 and 1983 is critical to AMC's forward product programs, and will preserve and create jobs at AMC's major facilities in the United States.

The last 2 years have been difficult for the U.S. automobile industry generally and for American Motors in particular. The industry over the last 2 years lost $5.6 billion. AMC lost about $330 million. But in spite of these losses, we are committed at American Motors to a new product program that will cost us about $1 billion over the next 3 years. This program is critical if we are to maintain our competitive position, particularly against foreign manufacturers whose governments actively encourage investments for both productivity and products.

AMC's capital planning and financial program for the new product lines include both external and internal financing. We have arranged about $600 million in financial agreements and capital loans. The accelerated cost recovery system and safe harbor leasing provisions of the Economic Recovery Tax Act of 1981 will enable us to raise at least another $100 million by sale of tax credits and depreciation on new investment. Thus, financial plans call for raising $700 million from external sources.

From internal sources, the company expects to raise $150 million from our employee investment plan which is currently being discussed with the United Automobile Workers. In addition, $150 million is expected to be raised through operations. With this additional $300 million from internal sources, the total capital funds of $1 billion will be achieved.

The Congress, recognizing the need to encourage productivity and maintain employment, included ACRS as the principal investment incentive in the tax law passed last year. Safe harbor leasing assures availability of ACRS during a period of reduced profit or loss. Industries such as ours, facing the greatest need for capital investment, are currently among the least profitable, and will not be able to benefit from ACRS for several years without safe harbor leasing. If safe harbor leasing is repealed, AMC would not receive the $100 million of the needed $1 billion. A cutback of such magnitude would result in delayed introduction of new products and severe reduction in employment.

Safe harbor leasing makes sense, and in our case it works. It creates no new tax credits. It permits the investing company to benefit from normal tax credits during the year in which those investments are made and the credits generated. It promotes a policy of tax equality in which the Government is equally supportive of investment by both profitable and unprofitable companies. It eliminates the pressure for profitable companies to merge with or buy unprofitable companies, to acquire the tax losses those companies may possess.

We are acutely aware that there has been a great deal of media and congressional attention given to the safe harbor provisions. Unfortunately, the important justification for the safe habor provisions has not been given equal attention. The freeze that has occurred in these transactions as a result of the famous February 19 cutoff has in effect repealed the safe harbor leasing provisions without congressional action. It is, in our judgment, legislation by proclamation, something that, to our knowledge, was not provided for in the Constitution.

We need your support for this program. It is critical because a 90-day window exists under which these credits may be sold, and as time passes, those 90-day windows are disappearing for many companies in this country. They need to be reassured, and the market needs to be reassured that they can in fact be restored, and the intent of Congress last year has not yet been repealed. We believe it should not be repealed.

When you examine the issue without emotion, I am personally convinced you will agree that safe harbor leasing can and will achieve the goals for which it was established—to preserve and create jobs by encouraging investment.

Thank you for the opportunity to present our position.

[The prepared statement follows:]

STATEMENT OF W. PAUL TIPPETT, JR., CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, AMERICAN MOTORS CORP.

I appreciate the opportunity to testify before the Ways and Means Committee today. On behalf of American Motors Corporation (AMC), I thank the Committee for the opportunity to explain the importance of retaining the Safe Harbor Leasing provisions [1] of the Economic Recovery Tax Act of 1981 (ERTA). My statement necessarily will focus on AMC.

The statement is divided into four sections.

Section I: Utilization by, and Importance to, American Motors Corporation of the Safe Harbor Leasing Provisions.

Section II: Economic Background and Congressional Debate Leading to the Enactment of Safe Harbor Leasing.

Section III: Rationale for Retaining the Safe Harbor Leasing Provisions.

Section IV: Conclusion.

SECTION I—UTILIZATION BY, AND IMPORTANCE TO, AMERICAN MOTORS CORP. OF THE SAFE HARBOR LEASING PROVISIONS

In 1980, AMC lost over $200 million. In 1981, the company incurred losses of $137 million. AMC has initiated tough short-term and long-term actions to reduce those losses and to ensure that its product offerings are fully competitive.

Short-term actions to reduce corporate losses have included a 13 percent reduction in the salaried workforce, a $60 million reduction in 1981 fixed costs, and a significant reduction in 1981 capital expenditures which are not related to new product programs. In November 1981, under regulations implementing Internal Revenue

[1] See Internal Revenue Code, sec. 168(f)(8).

Code section 168(f)(8)(G), AMC as a seller-lessee utilized Safe Harbor Leases and derived $10 million by selling the tax benefits associated with a $30 million new paint facility at the Jeep plant in Toledo, Ohio. Those funds were reinvested in new model product programs at AMC's Kenosha, Wisconsin and Toledo, Ohio plants.

In order to remain competitive, the company is committed over the long-term to new product programs which include the development and sale of a front-wheel drive fuel-efficient automobile to be built in Kenosha, Wisconsin, the development of a four-wheel drive Jeep line to be manufactured in Toledo, Ohio, and the development of a new fuel-efficient four-cylinder engine.

In order to complete those programs over the next four years, American Motors needs $1 billion in capital funds. However, because we are facing significant operating losses, we would be unable to benefit from the Accelerated Cost Recovery System (ACRS) without making use of the Safe Harbor Leasing provisions.

We estimate that the Safe Harbor Leasing provision will generate $100 million of the $1 billion needed between now and 1984. These funds will be reinvested immediately on product programs required for today's market.

AMC's capital planning and financial program for the new product line includes both external and internal funds. American Motors has received $600 million from financial agreements and capital loans. The ACRS and Safe Harbor Leasing provisions of the Economic Recovery Tax Act of 1981 will enable us to raise $100 million by sale of tax credits on, and depreciation of, new investment. Thus, financial plans call for raising $700 million from external sources.

From internal sources the Company expects to raise $150 million from the innovative employee-involvement plan which is currently being discussed with the United Automobile Workers. In addition, $150 million is expected to be raised through operations. With this additional $300 million the total capital funds of $1 billion can be achieved. AMC's ability to internally generate the projected amount from future operations is contingent on the preceding sources of capital funds, and particularly the amount to be derived from the sale of tax benefits, being available.

The Renault investment and the line of bank credit have been confirmed and committed to by the parties to those transactions. Thus, the capital funds to be generated by using Safe Harbor leases to sell future ACRS deductions and tax credits has become the pivotal element in AMC's fight for survival as a domestic automobile manufacturer.

If Safe Harbor Leasing is repealed, AMC would not receive a critical element of our capital expenditure program. $100 million of AMC's $1 billion capital expenditures would become unavailable. The cutbacks necessary to compensate for a reduction in capital expenditures of such a magnitude would necessitate rescheduling of production plans which would cause a delay in the introduction of new products. Further severe reductions in employment would also result.

SECTION II—ECONOMIC BACKGROUND AND CONGRESSIONAL DEBATE LEADING TO THE ENACTMENT OF SAFE HARBOR LEASING

Because capital investments do not always generate after-tax income immediately, many worthwhile investments would be unjustified without the Safe Harbor Leasing provisions. The leasing provisions promote tax neutrality. The Safe Harbor provisions ensure that investments with the same pre-tax return will have similar value to both taxable and nontaxable entities. The provision does not subsidize inefficiency. The leasing transaction permits the current utilization of the tax benefit but does not create an artificially high rate of return on a nonproductive asset relative to a productive one.

Repealing the Safe Harbor provisions would reinstitute a tax bias against productive assets where the assets' pattern of income generation does not coincide with their schedule of tax benefits. ACRS, coupled with the Safe Harbor Leasing rules, is a recognition by policymakers of the desirability of striving for tax neutrality in economic and investment decision making.

The Safe Harbor Leasing rules included in the Economic Recovery Tax Act were developed by the Office of Tax Policy in the United States Treasury Department. The leasing concept was included in this Congress' first bipartisan tax bill, the Hance-Conable Bill, H.R. 3849, which was introduced in the House on June 9, 1981.[2]

Mr. Conable's statement, in introducing H.R. 3849, indicated that the bill would liberalize the leasing rules and facilitate transfer of tax benefits.[3]

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[2] 127 Congressional Record H2824 (daily ed., June 9, 1981).
[3] 127 Congressional Record H2841, 2842 (daily ed., June 10, 1981).

The next stage of legislative consideration of the leasing provisions was in the Senate Finance Committee, which considered and reported H.J. Resolution 266. Senator Durenberger, a member of the Finance Committee, explained the need for the leasing provisions to his colleagues on the Senate floor.[4] Accelerated cost recovery and investment tax credit reforms were designed to promote capital formation and put Americans back to work. The tax incentives benefited only industries that were already yielding profits and hence had a tax liability against which to apply the incentive.

As Mr. Durenberger stated:

"Unfortunately, the industries facing the greatest need for retooling—because they have the oldest physical plant—are also among the economy's least profitable. Steel, automobiles, rail, airlines, and mining are good examples. These basic industries have three troublesome factors in common:

"First, each is a true basic industry, employing large numbers of people and producing a product essential to the nation's economy;

"Second, each is facing immense capital investment needs as it seeks to modernize aging plants and equipment; and

"Third, in the face of these growing investment needs, each of these basic industries is facing inadequate earnings on an industrywide basis." [5]

No one could deny that modernization of those basic industries is essential to America's reindustrialization plan and to its future. But it is equally true that most of the tax incentives contained in the tax bills proposed during 1981 would have had little or no impact on companies such as AMC because we had no taxable earnings. Corporations generate income in differing patterns over their respective lifetimes. The fact that a particular industry or company within an industry produces no net income in a specific year does not mean that such an industry or corporation is not capable of income-producing investment.

The Reagan Administration as well as the Senate Finance Committee recognized this. The Finance Committee adopted language that liberalized the restrictions on leasing.

Following thorough debate, the Senate rejected an amendment which would have deferred the effective date of the Safe Harbor Leasing provisions. During that debate, Senator Dole, in a very clear and concise manner, justified the need for the leasing provisions. He explained who would benefit from them and how the provisions effectuated the necessary capital transfers. For the Committee's reference, the relevant part of Mr. Dole's floor statement is attached as Exhibit A. Chairman Dole also provided an analysis of leasing benefits by state and industry as follows:

Alabama, steel, paper; Arizona, mining; California, autos; Colorado, mining, airlines; Georgia, paper; Idaho, mining; Illinois, steel; Indiana, steel; Kentucky, autos; Michigan, autos; Minnesota, iron; Missouri, autos; Montana, mining; Nevada, mining; New Mexico, mining; North Carolina, paper; Ohio, steel, autos; Oregon, paper; Pennsylvania, autos, steel; Tennessee, paper; Texas, airlines; Utah, mining; Washington, paper; Wisconsin, paper; and Wyoming, mining.

SECTION III—RATIONALE FOR RETAINING THE SAFE HARBOR LEASING PROVISIONS

Recently, the Safe Harbor Leasing provisions have been subjected to pressure for repeal due to misconceptions reported in the press. Those articles have oversimplified the transactions and have not focused on the impact of the leasing provisions in providing an additional source of financing for capital investment.

However, there has also been some press support for the Safe Harbor provisions. On March 2, 1982, the New York Times editorialized that "(T)here are juicier targets than tax leasing." The editorial stated in part:

"The purpose of the 1981 law was not to establish some specific corporate tax level, but to subsidize investment. Eliminate tax leasing and you arbitrarily limit the available subsidy to the size of any corporation's income tax. Rapidly growing concerns with huge investments would lose out. So would unprofitable ones that need to modernize to compete."

Thus, the reasons that justified inclusion of Safe Harbor Leasing in the 1981 ERTA were that:

ACRS is the principal investment incentive in the new law—intended to create jobs and put Americans back to work.

Safe Harbor Leasing assures greater utilization of ACRS during periods of industry-wide reduced profits or losses.

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[4] 127 Congressional Record S7647, 7648 (daily ed., July 15, 1981).

[5] Id.

Without Safe Harbor Leasing the accumulation, in nontaxable companies, of large amounts of unusable ACRS deductions would create a pressure for profitable and unprofitable companies to merge into single economic entities.

Industries facing the greatest need for capital investment are among the least profitable (auto, steel, airline, rail, mining) and will be unable to benefit from ACRS for several years.

Assures ACRS benefits are distributed evenhandedly between currently profitable and unprofitable companies.

Tax benefits are passed through to the company making the new investment.

No extra deductions or tax credits are ever created.

The rationale for retaining the Safe Harbor provisions has not changed since the legislation was enacted. The leasing mechanism enables many companies to utilize ACRS, thus increasing investment and creating jobs during these difficult economic times.

SECTION IV—CONCLUSION

AMC urges Members of the Committee to support retention of the Safe Harbor provisions. If, after objective review of the provisions, Congress deems it necessary to modify the current version of the statute, AMC would support responsible amendments that would correct the perceived inequities. If any modification of the statute is undertaken, AMC asks that the intent of the Safe Harbor provisions be retained so that distressed industries, such as the auto industry, would still be able to generate needed capital through the sale of their tax benefits.

Upon having reviewed this statement, if you have any questions or comments, please do not hesitate to call American Motors' Washington D.C. office at (202) 347-1292.

EXHIBIT A

[From the Congressional Record—Senate, July 21, 1981]

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Mr. DOLE. Let me discuss one other aspect of the amendment of the Senator from Texas, and I will be happy to yield to my colleagues.

The distinguished Senator from Texas has proposed an amendment which would defer for 10 years the liberalized leasing rules of the Finance Committee bill. This amendment provides a difficult decision for the Senate. The leasing provisions are complex and highly technical. The present law that it changes is even more technical and complex. But the purpose of the provisions is clear to make the economic recovery provisions of the tax bill work.

WHAT THE LEASING RULES ARE

The leasing rules provide a safe harbor for taxpayers. Those taxpayers who seek to enter into leases of new property will be permitted to characterize their agreements as leases and thus to designate another party as the owner for Federal tax purposes. The amendment maximized the freedom of taxpayers and expands the free market for equipment leasing.

The effect of designating a corporation—other than the user—as the owner for Federal tax purposes will be to permit the designated owner to take the investment tax credit and the depreciation deduction. The effect will be to permit taxpayers to bargain among themselves to identify the taxpayer who will obtain the greatest benefit from the tax attributes. The result will be to maximize the investment incentives from ACRS because ITC and depreciation deductions will not go to waste.

WHO NEEDS LEASING?

Leasing is particularly important for a wide range of enterprises which will be crucial to the economic recovery of our nation. One constituency for leasing will be our heavy, distressed industries. Because of the long-term effects of our prior tax policies which were biased against investment, productivity and profits in our most capital intensive industries have fallen. As a result, many companies in such industries are not in a position to best take advantage of tax incentives. The leasing provisions will enable such companies to do indirectly what they cannot do directly.

But the need for leasing is much broader. Our best estimate of the share of the revenue loss attributable to our six basic distressed industries—iron and steel, and

automobile manufacturing foremost among them—is only about 25 percent. Where does the other 75 percent go?

We believe, based upon economic analysis by the Joint Committee on Taxation, that the remainder of the benefits will also go to important players in the effort to bring America out of its economic decline. Small, rapidly growing businesses will benefit greatly from this provision. Such taxpayers in the lower brackets of our corporate income tax will be able to transfer tax deductions to corporations which will be able to offset such deductions against income in a 46-percent bracket. These small companies will thus also be part of the dynamic engine that will restore American economic growth. Such businesses have historically been responsible for many of the innovative ideas and new jobs created in America.

HOW THE LEASING RULES WORK

The leasing rules operate by permitting private contractual arrangements to determine which of two parties—the user and the financing party—will be treated as the owner for Federal tax purposes. The leasing markets are a well-established and dynamic financial market for this country. There are established methods and procedures through which investment credits and depreciation can be transferred. Those private legal precedents will easily adapt to the new lease transactions. Above all use of the lease rules will insure that economic investments will be made.

ALTERNATIVES TO LEASING

The failure to provide liberalized leasing rules will effectively guarantee that we will adopt a refundable investment tax credit in the near future. Currently there are unused investment tax credits of approximately $14 billion. That amount will grow at a substantial rate. Either we will forego much of the intended effect of the economic stimulus package or we will be forced to adopt a refundable ITC. Of course, an after-the-fact ITC will be less cost effective, with a larger revenue loss, than liberalized leasing rules.

Liberalized leasing rules are the best way to maximize the benefits of ACRS without the enormous revenue loss of refundable ITC's and its unestimable administrative costs. I urge my colleagues to defeat the amendment.

Who is going to be affected by this? The principal industries that will benefit from the leasing provisions include automobile manufacturers, iron and steel producers, railroads, airlines, copper mines, and paper.

The geographical distribution of benefits will be wide. I ask unanimous consent to have printed in the RECORD a table showing States to which major benefits will accrue.

There being no objection, the table was ordered to be printed in the RECORD, as follows:

Alabama, steel, paper; Arizona, mining; California, autos; Colorado, mining, airlines; Georgia, paper; Idaho, mining; Illinois, steel; Indiana, steel; Kentucky, autos; Michigan, autos; Minnesota, iron; Missouri, autos; Montana, mining; New Mexico, mining; Nevada, mining; North Carolina, paper; Ohio, steel, autos; Oregon, paper; Pennsylvania, autos, steel; Tennessee, paper; Texas, airlines; Utah, mining; Washington, paper; Wisconsin, paper; and, Wyoming, mining.

Mr. ABDNOR assumed the Chair.

Mr. DOLE. Finally, Mr. President, I wish to conclude on a positive note and again to commend the Senator from Texas for offering the amendment. I cannot say that I want the Senator from Texas to prevail, but he has brought this matter to the attention not only of the Senate, but also the administration and the country, and for that reason he has provided a service.

I believe we do have a better idea, and we believe our idea will add more of a production response and is parallel with the President's so-called supply-side economic theories and supply-side tax cuts.

What better incentive could you give anyone than to phase out the tax they now pay, whether it is levied on oil or on anything else? It seems to me that the production response will be immediate. It is going to affect those out there looking for oil right now, not someone who has it and is waiting for an exemption to come along.

I suggest that the best way to proceed—and I hope this will be followed on a bipartisan basis—would be to dispose of this amendment. Then, the Senator from Kansas has an amendment pending which will follow all the discussion and the vote on this amendment and which, as I said, will eliminate the tax on new oil over 4 years, by 7.5 percent a year.

An amendment in the second degree will be offered to that amendment, to take care of tertiary and heavy oil—the oil produced in the State of the distinguished

Senators from California (Mr. CRANSTON and Mr. HAYAKAWA). Tertiary oil is important to the State of Texas and the State of Oklahoma and also, to some degree, to the State of Louisiana. So we are not leaving without a solution. We are being positive in our attacks on this.* * *

Chairman ROSTENKOWSKI. Mr. Borman, you may proceed.

STATEMENT OF FRANK BORMAN, PRESIDENT, EASTERN AIRLINES, INC.

Mr. BORMAN. I am Frank Borman, president of Eastern Airlines, and I would like to summarize, sir, by asking you to focus on five slides I have, if I may.

The first slide. The other gentlemen have talked about their companies or their industries. I would like to present a case study of an individual purchase of equipment that is important to Eastern Airlines, and I am talking about the Boeing 757. First, let me give you a glimpse of the industry in general, with the next slide.

[Slide.]

Mr. BORMAN. Twelve carriers had a net loss of $733 million last year. The most successful, Delta, had a profit margin of only 2.5 percent. Eastern was about in the middle from the standpoint of performance. I might point out that these 12 carriers, even in the face of almost $1 billion loss, have on order 15 billion dollars' worth of equipment in the form of 400 new airplanes, most of them with Boeing, although some are on order from Lockheed and Douglas.

It is important to notice that since the safe harbor leasing has come into question, United has announced that they are putting on hold 1 billion dollars' worth of equipment that was to be delivered in 1984 and beyond, 27 567's, and as a result of this performance in the industry and the safe harbor leasing uncertainty, American has canceled another 1 billion dollars' worth of 757's that were to be delivered in 1984 and beyond.

In Eastern's case, in 1978, the most profitable year in our history, we ordered 757's. In the next slide, this shows you that we were indeed, along with British Airways, the kickoff order.

[Slide.]

Mr. BORMAN. We have 22 airplanes to be delivered in 1983, 18 after that, and, of course, 64 basically Delta airplanes that are to be delivered in 1984 and beyond. We had had 4 of the most profitable years in the airlines in Eastern's history when we placed the order in 1978, but because of the recession, the enormous increase in the price of kerosene that has gone from 11 cents a gallon to over $1 a gallon, and because the airline industry is adjusting to deregulation, the act that was passed by the Congress and signed by President Carter in 1978, we have had a string of very unsuccessful years. In recognition of this, I was meeting with Boeing in July of 1981 to either cancel a third of our orders or extend the delivery. Then, in August, you passed—the Congress passed and the President signed—the safe harbor leasing provisions, and the next slide will show you what that did for us.

[Slide.]

Mr. BORMAN. We were able to arrange with Rolls Royce, who powers this airplane, for some export credit. Boeing allowed that they could come through with some additional subordinated financ-

ing, and safe harbor leasing provided us with almost a third of the financing required. We had the ability for investment equipment trust certificates, and we went to Boeing in August, after the safe harbor leasing was passed, and said, we will go ahead with the order. Forget that we were out here talking about canceling, because with this we can go ahead, and we were proceeding along our way. Employees contributed through salary reductions, and we sought a way through the maze of the problems that exist in the airline industry.

Then Senator Dole made his speech on February 19, and immediately this very, very difficult but doable plan was cast into jeopardy.

Now, quite obviously, this $273 million would be available through a profitable company, and echoing what the other gentlemen have said, if you repeal safe harbor leasing, you have essentially increased the cost of capital to the marginal companies by as much as 30 percent, and you have absolutely insured that the rich will get richer and the poor will get poorer in a corporate sense.

Next slide.

[Slide.]

Mr. BORMAN. Finally, people say, well, why don't you use leverage leasing. Particularly the leasing companies would very much like to have us use leverage leasing, because they get a very, very much larger percent of the benefits under a leverage situation. This is leverage versus safe harbor from our standpoint.

In the first place, we can only use leverage leasing because of indentures in our mortgage up to 50 percent of our fleet. Safe harbor, 100 percent. We do not get any up-front equity benefit from leverage. We get enormous up-front benefit from safe harbor. In the leverage leasing, we give up ownership.

A good example, 15 years ago we leverage leased 23 DC-9's. Those leases come up in 1982 and 1983. We have paid rent on them, if you will, for 16 years. Now we have to buy them again at fair market value, which is more than they were when we purchased them, so after paying them for 16 years, now we have to go and pay the lessors the fair market value, which is more than the original cost of the equipment. It is a small wonder that the leasing companies do not want safe harbor leasing to continue.

Under safe harbor leasing, we maintain ownership, and of course this talks about the part that I just mentioned. It is not, in my view, a subsidy. It is simply a manner of keeping a playing field level in an industry in which currently almost all of the players are distressed.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF FRANK BORMAN, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, EASTERN AIR LINES, INC.

I appreciate the opportunity to appear before the House Ways & Means Committee to testify today on the vital importance of the safe harbor leasing provisions contained in the Economic Recovery Tax Act of 1981. My remarks understandably will focus on Eastern Airlines, but I speak also on behalf of other member airlines of the Air Transport Association.

The purpose of my testimony is to express my most serious concern over the possibility of early repeal of the tax transfer provisions allowed by safe harbor leasing.

Without these provisions, the investment incentives of the accelerated cost recovery system will surely bypass many of the industries it was intended to stimulate.

For Eastern Airlines, repeal would put in question $1 billion worth of procurement, involving thousands of jobs throughout the nation. The ATA reports that for the airline industry as a whole there are 400 aircraft on order or option with a value of more than $15 billion, whose procurement could be cancelled or delayed if the leasing provisions are repealed. Clearly, repeal would have a drastic impact on fleet modernization that is necessary to increase productivity, create jobs and strengthen the competitive posture of the nation.

Let me say at the outset that I fully recognize the need to eliminate abuses, but I strongly believe there are situations where safe harbor leasing is essential to maintain or stimulate economic activity which otherwise would be lost at a net penalty to the economy of our country.

I am here to describe one specific case where safe harbor leasing would accomplish specifically what Congress intended when it acted last year to stimulate capital formation and investment on an equitable basis. This case involves Eastern and its order for the new technology Boeing 757 airplane. I want to make three points.

1. Eastern ordered the 757 aircraft at a time of profitable operations.

2. When the airline industry, together with many other industries, was hit by two successive recessions, inflation and high interest rates and sustained record losses, Eastern was forced to reconsider the 757 order.

3. Safe harbor leasing made it possible for Eastern to pursue its billion-dollar investment plan.

On February 23, 1982, I informed the Chairman and members of this Committee:

"As a member of an industry which has been severely buffetted by the introduction of deregulation and the current recession, the retention of the leasing provisions of the Act are absolutely essential—if Eastern Airlines is to proceed with any assurance of consummating its planned purchase of new fuel efficient Boeing 757 aircraft over the next two to three years—valued at nearly one billion dollars.

"At a time when increased investment and creation of jobs are urgently needed to get our nation's economy moving in the right direction, it would seem counter-productive to take action which—in our case—could produce the exact opposite result. If any changes are made, we urge that the basic concept of leasing be retained, particularly as they apply to industries like airlines."

The Boeing 757 aircraft is a new technology, narrow-body, twin engine, fuel efficient airplane designed for short to medium range operations with capacity for 185 passengers in Eastern mixed configuration.

In 1978, when the airline industry was achieving a satisfactory profit level, Eastern became one of the launching customers for this new aircraft. The 757 program is on schedule and the first flight of this aircraft took place on February 19 of this year. The FAA type certification is expected in December, 1982 or January, 1983.

Eastern has entered into firm purchase commitments for 27 Boeing 757 aircraft. Deliveries span a two-year period starting in December, 1982 and ending in December, 1984. The total estimated purchase price for these aircraft, before any spares provisioning, but including cost escalation, is $909 million. Exhibit A shows deliveries and prices by year.

The question could arise as to why a capital investment program committed in 1978 now is linked for its fulfillment to tax provisions enacted in 1981. There are two ways of answering this question. One, of course, is the unforeseen downturn since 1978 in the economy in general and the airline industry in particular. The airline industry sustained record losses in 1980 and 1981 and for the 12 months ending June, 1982, operating losses could reach $1 billion. Thus, given this situation, safe harbor leasing provides an urgently needed economic incentive by reducing the high risk of financial difficulties in the early part of a new technology program.

Boeing launched the program in 1978 with 40 firm orders for delivery in 1983 and 1984.

After almost four years, Boeing's order book for the period 1983 and 1984 has only increased by 17 units to a total of 57. Other orders have been received but for years subsequent to the important start-up period. Exhibit B provides information concerning Boeing 757 orders.

I want to emphasize that when Eastern became a launching customer for the 757, Eastern was completing a record profit year, its third consecutive profitable year. Eastern's financial plan, as stated, was based on achieving a minimum 2 percent profit margin on revenues. This expectation was judged reasonable and conservative, especially as this minimum profit objective is supported by an employee variable earnings program. Further, Eastern obtained a $400 million revolving bank

credit commitment in 1980 to provide additional insurance in financing the commitments of the B757 program.

Unfortunately, the initial profit expectations have not been materializing (as shown in Exhibit C) reflecting a downturn in earnings which is widespread in the airline industry. Exhibit D shows earnings for the major airlines for the calendar year 1981 where Eastern ranks sixth out of a total of 12 carriers in terms of net earnings margin on revenue.

Combining developments at Boeing and Eastern, the situation today finds Boeing with a minimum level of orders and Eastern facing difficult capital markets.

The second reason why the B757 situation is particularly illuminating as to the criticality of safe harbor leasing relates to the fact that Eastern did not pursue the restructuring of the program in 1981 because of the Congressional action on safe harbor leasing.

Confronted with economic realities, in July of 1981, I met with management of the Boeing Company to review the need to restructure the program. When safe harbor leasing was adopted, a new element was brought into the financial planning of the program and discussions relating to restructuring it were discontinued. In short, safe harbor leasing made it possible for Eastern to go forward with the order. The situation today is markedly different. Boeing is totally unable to restructure the program, and if safe harbor leasing is repealed, Eastern's ability to proceed with any assurance of consummating its planned purchase of these Boeing aircraft is open to question. In summary, we relied in our planning on the leasing provisions of the Economic Recovery Tax Act of 1981.

I believe that the leasing provisions will accomplish the purposes Congress intended. If there is a need to modify this legislation to prevent abuse, then changes should be made, but repeal would have drastic consequences for capital intensive industries, such as the airlines, and would result in the loss of scores of thousands of manufacturing and other jobs throughout the nation.

EXHIBIT A—EASTERN'S COMMITMENT

[Dollar amounts in millions]

	1982	1983	1984	Total
Number of aircraft	2	11	14	27
Average unit price	$29.8	$31.8	$35.7	$33.7
Total cost	$59.6	$349.6	$499.7	$908.9

EXHIBIT B—EASTERN'S B–757 ORDER IS OF VITAL IMPORTANCE TO THE EARLY PART OF THE BOEING PROGRAM

	Delivery dates			Total firm orders
	1983	1984	After	
Launching orders in 1978:				
Eastern	11	10		21
Others	11	8		19
Total	22	18		40
Firm orders as of March 1982:				
Eastern	13	14		27
Others	17	13	64	94
Total	30	27	64	121

EXHIBIT C—PROFIT EXPECTATIONS ARE NOT MATERIALIZING

[In millions of dollars]

	Profit (loss)		Improvement (deterioration)
	1978 expectations	Actual or new estimates	
Calendar year:			
1978	59.1	67.3	8.2
1979	42.1	57.6	15.5
1980	52.5	(17.4)	(69.9)
1981	60.0	(65.9)	(125.9)
Subtotal, 1978–81	213.7	41.6	(172.1)
1982	68.0	[1]	[1]
1983	74.8	[1]	[1]
1984	82.3	[1]	[1]

[1] Unknown.

EXHIBIT D—1981 AIRLINE PERFORMANCE [1]

[Dollar amounts in millions]

Ranking by net margin and airline	Revenues	Net income (loss)	Net margin (percent)
1. U.S. Air	$1,110.5	$51.1	4.6
2. Delta	3,638.6	91.6	2.5
3. American	3,915.0	47.4	1.2
4. Northwest	1,843.9	10.5	.6
5. Trans World	3,420.4	(25.1)	(.7)
6. Eastern	3,727.1	(65.9)	(1.8)
7. United	4,541.7	(104.4)	(2.3)
8. Republic	1,448.4	(46.3)	(3.2)
9. Continental	1,079.3	(60.4)	(5.6)
10. Western	1,059.8	(69.4)	(6.5)
11. Pan American	3,574.4	[2] (397.9)	(11.1)
12. Braniff	1,214.2	(160.0)	(13.2)
Total	30,573.3	(728.8)	(2.4)

[1] Eastern's earnings erosion is characteristic of the industry as shown by the 1981 data for the 12 major airlines.
[2] Excludes sale of hotel properties.

Chairman ROSTENKOWSKI. Thank you all. I would like to make an observation. I certainly realize that this is probably the most highlighted section of the tax legislation that was enacted last year. You have all been reading the newspapers. I must admit that the performance of safe harbor leasing, as reported by the press, has been very negative. Gentlemen, you have to agree that those of us who have to respond to our constituencies respond, in part, to what the press is reporting. In passing the Economic Recovery Tax Act, we tried to stimulate investment and productivity. There is no section of last year's bill that is more controversial than safe harbor leasing. Several bills have been introduced to repeal safe harbor leasing. I had a conversation with Senator Dole before he made his February 19 speech in Wichita. I think it is more prudent for us to receive your testimony and find out the ramifications of safe harbor leasing before we legislate.

Do you all oppose the legislation that would repeal safe harbor leasing? Or can you suggest some modifications in the area that this committee should consider?

Mr. CONABLE. Mr. Chairman, I want to confirm what you have said. As you know, I have been defending safe harbor leasing around the Hill, and there are very few people who have. It is very hard to roll a snowball back up the hill after it has started down in this environment. It is obvious we are going to have to do something. We can either repeal it or modify it or recertify it as it is.

Of the three, the most achievable politically is some modification of it that will permit a market in tax credits to develop, and at the same time dealing with perceived abuses in the area. So I wish you would put your massive minds to work on modifications here in order that we can preserve some aspects of safe harbor leasing because it is a valuable tool for people like you. I think your testimony here has been very important for that reason.

I just want to piggyback on what the chairman has said and confirm that we do need to address that question because of the political environment that has developed here.

Chairman ROSTENKOWSKI. Mr. Seidman.

Mr. SEIDMAN. Thank you, Mr. Chairman and Mr. Conable.

I would like to make two comments with respect to the public perception and perhaps what might be done to help the public understand better what is really happening here. I think the first thing in the headlines that I have seen that have raised the most difficulty have been of the type that said that very large, profitable companies were paying no taxes.

That clearly has been the one that has perhaps received the most attention. We are certainly in favor of changing the provisions in any way where there is a demonstratable abuse of the provisions. If in the case of those headline grabbers it appears important to change, it seems to me that it could be quite easily done by simply capping the amount that any purchaser or lessor could use to reduce his taxes.

That would be a relatively simple provision. It might be that he could not eliminate more than 60 percent or 50 percent of his taxes. From our point of view, a seller or lessee, that would reduce to some extent the buyers in the marketplace perhaps, but our experience is, I think, that there would still be sufficient buyers to keep a fair value in the marketplace. So from that point of view we would not oppose such a position.

There have been other stated abuses or claimed abuses which I do not think have been, at this point, at least, to our knowledge, demonstrated in a way that we would know how to suggest what should be done by the Congress. If there are other kinds of abuses demonstrated, we would certainly like to work with your committee in any way to try to develop provisions. We really do not know of any that have received great publicity except that particular elimination and carryback, which, incidentally, was by a company that was in the leverage leasing business.

Chairman ROSTENKOWSKI. Is there any further comment? If not, Mr. Gibbons will inquire.

Mr. GIBBONS. First I want to thank you, Mr. Borman, for that very graphic and very pointed illustration of what this means to your company and to other people who are in a marginally profitable business.

Mr. Tippett, I want to go to your company. Maybe you will not want to talk this much about your income taxes, and if you want to pursue this conversation privately, I will understand. But I want to ask you some kind of pointed questions to get to it.

I think American Motors has been struggling for a long time, and it is my general impression that they have not had to pay a lot of Federal income tax because they had been in a marginal position.

Let me ask you: In the seventies were you able to take advantage of the investment tax credit?

Mr. TIPPETT. I believe we were. I will have to check on this, Congressman. I believe we were in at least 1 or 2 years able to do that.

Mr. GIBBONS. In 1 or 2 years out of the 10.

Mr. TIPPETT. Yes. One of our problems as a company has been we have not had a sustainable long-range product program. We now with this billion dollar investment program have one in place. We have the financing from both inside and outside to provide a steady stream of new products that will put us in a profitable position on a continuing basis.

We were profitable for 2 years and then not profitable for 2 years, and this safe harbor leasing is absolutely critical to the execution of that plan.

Mr. GIBBONS. What I am trying to point out is the investment credit as it has been arranged for all these years by Congress really puts an added burden on the marginally profitable company while it rewards, probably excessively, the profitable company.

Mr. TIPPETT. Yes, sir.

Mr. GIBBONS. And I think that that is one of the characteristics of the investment credit inherently. That is a characteristic that has followed for years. As I look at your industry, General Motors has been able, I think, in all of the years in the seventies, to take full advantage of the investment credit, and some of your other competitors like Chrysler and Ford have had roughly the same sort of history that you have had.

So between the four of you, one kept getting stronger and stronger and stronger, and the other three kept getting less competitive—that is the way I read the picture.

Now, do you agree with me on this or don't you?

Mr. TIPPETT. I think there is no question about that. Currently, at least, the only company, domestic U.S. automobile manufacturer that would be able to take advantage of the ACRS provisions of last year without inclusion of safe harbor leasing would be General Motors.

Mr. GIBBONS. I think it is fair to say, without going into General Motors' tax return, just on their K–10's they have been filing, which are public information, that they have been able to take advantage of it all these 10 years and the other American competitors have been penalized in relation to GM because they have not been able to use the investment credit

Mr. TIPPETT. If I may also say, Congressman, as you are well aware, one of our strongest competitors is not a U.S. competitor, and that is Japan, Incorporated. They have extremely attractive tax provisions in their investment programs over there. Investment, for example, relating to export programs can be written off

in 2 years and that sort of thing. We are competing against that kind of competition here in this country.

Mr. GIBBONS. I am not going to jump on them. I tried to give you an investment you could write off in 1 year, and you all rejected it last year. So there is no sense to our beating that horse any more.

Mr. Penick, would you explain for the committee again what are the differences and what are the advantages between safe harbor leasing and the old type of leverage lease.

Mr. PENICK. I think Mr. Borman identified some of those. I would say the most critical difference is what we would call the residual value, or under the old leverage leasing approach, the lessee, the user of the equipment, in essence would have to buy the equipment at the end of the lease term to have continued use of it.

In the safe harbor lease approach, the user of the equipment in essence is the owner of the equipment as long as the equipment is usable. That to me is the most critical difference right there.

Mr. GRADISON. That is the most critical difference?

Mr. PENICK. Yes; as Mr. Borman and one or two of the other gentlemen have indicated, and I think this is a good ballpark figure, under traditional leverage leasing there generally has been about a 50–50 split between the lessor and the lessee on the tax benefits, and whether our calculation of 90 percent or the Treasury's of 84 percent, or the joint committee, of course, has a tentative lower figure, 70-some odd, regardless of which of these would apply, it is still substantially better than leverage leasing.

There is one other difference, too. Under the traditional leverage-leasing concept there are severe limitations on the kind of equipment that can be used. They generally have to be general purpose equipment and a special purpose item which is not usable by another taxpayer. In essence you cannot use leverage leasing. That is not so for safe harbor.

Mr. TIPPETT. If I may add, that particularly applies to the automobile business, that last point. An airplane, for example, could be used in a leverage lease or a truck, but most of the equipment we are purchasing is special purpose, designed to produce a specific kind of automobile which has no value to another taxpayer.

Mr. DICKEY. Can I make one comment on that, I don't want to be redundant, because the same things would apply to the paper industry that had been mentioned by these other gentlemen. There is one other point that I think is worth noting, and that is in leverage leasing the percentage that goes to lawyers, underwriters, et cetera, is a great deal higher than it is in safe harbor leasing. There is an enormous complexity involved in a leverage leasing deal which takes a great deal of time and a great deal of money.

Mr. GIBBONS. Thank you, Mr. Chairman. I have some more questions, but I will come back.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank the panel. And Mr. Borman, may I say that I think you are going to have a better year, having just announced this month that you are offering service in Knoxville, my hometown. We wish you the very best.

Mr. BORMAN. Thank you, sir.

Mr. DUNCAN. Short of total repeal, how could the alleged abuses about which we are talking be curtailed, while still retaining some of the desirable features of, say, a proper leasing? Would some of you care to elaborate on that question? How could you curtail some of the perceived abuses that we have been reading about?

Mr. Dickey?

Mr. DICKEY. Could you repeat the question?

Mr. DUNCAN. Short of total appeal, how could the alleged abuses that we have been talking about be curtailed while still retaining some of the desirable features of safe harbor leasing?

Mr. DICKEY. I come to the same conclusion as I think Mr. Seidman did when he talked earlier about the possibility of a cap. There are all kinds of very, very complicated mechanisms that I think can be dreamed up, but they are so complicated that they are probably not viable. The cap solution or a solution along those lines is the one that would be viable and I think would be acceptable.

Mr. DUNCAN. Would any other member of the panel care to answer that?

Mr. TIPPETT. I do believe there is one other that should be examined. In the current law there is a carryback provision which would in effect require the Treasury to write a check for past taxes paid to offset past taxes paid. That has gotten a great deal of publicity as well, and in addition to the cap, the carryback provision could be eliminated. Only the benefits to the lessor could be restricted to carry forward provisions.

Mr. DUNCAN. What is your thought on the carryback, Mr. Borman?

Mr. BORMAN. Sir, I agree with the comments of the other gentleman. I think the cap would be the most important that we could do to begin with.

Mr. CONABLE. Will the gentleman yield?

Mr. DUNCAN. I would be glad to.

Mr. CONABLE. I would like to ask the panel, if they don't see the inclusion of the investment tax credit and depreciation credits, also under the minimum tax, as possibly affecting the market in tax credits and therefore not being as desirable as the kind of limitations that Mr. Seidman was talking about.

There have been suggestions, you know, that this be put under the corporate minimum tax. That would inject an element of risk and uncertainty, as I see it, into the value of the credits, so that it would become a buyer's market again; would it not?

Mr. DICKEY. Yes, sir, totally.

Mr. PENICK. I would fully agree with that. The fact that this could be included as a preference element under the new alternative minimum tax system I think clearly is already having some effect. But once you put the benefit to the buyer, make them subject to some sort of minimum tax, you clearly change the economics to him, which is another way of saying you change the price, really, that he can pay to the user of the property if he has to pay the minimum tax.

Mr. CONABLE. Thank you.

Mr. DUNCAN. Thank you, Mr. Chairman, and I thank the panel.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Borman, I assume your company had entered into this safe harbor leasing last year after we passed our tax bill, or had you already entered into this transaction or made a commitment to it?

Mr. BORMAN. We made the commitment for these airplanes in 1978, for the Boeing 757's, but we were in July at Seattle talking cancellation and/or extension when the safe harbor leasing bill was passed in August. Consequently, we reaffirmed our order in August with some assistance from Boeing and with assistance from export financing for the engines. We then said go forward.

Mr. PICKLE. Then as we were entering into this procedure, you changed to take advantage of the——

Mr. BORMAN. Yes, sir.

Mr. PICKLE. Can you tell me what company bought your tax benefits?

Mr. BORMAN. We have not sold them for the 757 yet, sir. I was just giving you a case study of airplanes that are going to be delivered later this year and that we are counting on for finance in those cases.

Mr. PICKLE. I am trying to find out what company in America, or is it an international company?

Mr. BORMAN. We will have to sell them as the airplanes are delivered. We cannot sell these investment tax credits or the accelerated until we have the airplane. Now, the major market has been traditional leverage leasing companies in some cases. I read that IBM bought some, I believe, and I believe we did some ground equipment financing with Merrill Lynch.

Mr. PICKLE. I am trying to identify the company or companies with whom you are going to enter into a safe harbor leasing procedure.

Mr. BORMAN. To be honest with you, since February 19 we have not been able to find anyone to talk about the airplanes that we had planned to finance this way because, at least it is our experience that no one will talk to us about leases now.

Mr. PICKLE. Mr. Penick, you mentioned that one company had received 100 percent exemption from tax liability. Can you identify the company?

Mr. PENICK. No, sir, I cannot. Many of the companies we surveyed requested confidentiality of their information, and we do not know which company is associated with which data. Each has a code number.

Mr. PICKLE. So your survey came back without the company identified.

Mr. PENICK. That is correct.

Mr. PICKLE. And only one showed 100 percent exemption from tax liability. Can you tell me how much that was in terms of dollars?

Mr. PENICK. Do you mean the size of it?

Mr. PICKLE. Was it $1 billion, $200 million, or what?

Mr. PENICK. I will have to check that and give you a response. I cannot tell you right now.

Mr. PICKLE. I would like to have that information. I think it is important for us to see how it works.

Mr. PENICK. Excuse me, sir. We did indicate the average of the companies surveyed was roughly 40 percent of their liabilities.

Mr. PICKLE. Yes, I noticed that. So the question is, If we put a cap, do you go to 40, 50, or 60 percent? But you would not recommend 100 percent.

I am also interested in knowing the size of these credits. I guess the question comes down really to, does the government finance this kind of procedure through safe harbor leasing, or does the leverage leasing procedure finance it? And you would rather have the safe harbor than the leverage leasing.

Mr. PENICK. Sir, our report was not intended to support safe harbor leasing or oppose safe harbor leasing. Of the companies we surveyed, it was clear in their minds that they are better off, they get a better benefit under safe harbor leasing than under leverage leasing.

Mr. PICKLE. Yes; I assumed that that was your point, that they would be better off with it; but the question is did they use that procedure or the leverage leasing, and you said that your survey showed that they would have still been able to get financing probably from another source, although it might be at a higher cost.

I really think it is a question of who picks up the tab. That is what it boils down to.

Mr. TIPPETT. Congressman, just to give you a small example included in my testimony, we did in fact build a new paint facility in our plant in Toledo for $30 million. We received $10 million back from the purchaser of that lease. It happened to be Liberty Mutual Insurance Co. in this case.

In the automobile industry there is not a wide variety of additional financing sources available, so contrary to what Arthur Andersen may have reported for some industries, there are other industries where additional financing sources are not available because of the tremendous requirements the industry currently faces. So there are not a lot of options.

Mr. BORMAN. Sir, may I add one thing? I believe whether you use leverage leases or safe harbor leases, in the final analysis you are selling incentives that the government has provided for investment. Consequently, it is all going to flow eventually back to those incentives. In the safe harbor leasing we have far, far fewer restrictions and a great many more of the benefits flow to the people who use and buy the equipment, not to the middle man.

Mr. PICKLE. I would agree with you that the incentive is there and you would like that.

Mr. BORMAN. Yes, sir.

Mr. PICKLE. But the question also is who pays for it; how much can the Government pay for at a time when we have such a high deficit? There are going to be some changes in this overall tax procedure, and I think we better think in terms of how we can adjust it or else it may just be repealed.

Mr. BORMAN. Yes, sir. My point in trying to respond to your question is I think that in the final analysis the Government provides the incentives whether it is under leverage leases or safe harbor leases, but in the safe harbor leases it flows more directly to where you want it to flow.

Mr. PICKLE. Well, the American public objects to a situation like General Electric who can take advantage of these deals to offset a great deal of tax liability.

The American people, just average folks, say that is wrong.

Mr. BORMAN. Yes, sir, and I think by capping the amount of the tax they could offset, I think you would illuminate that reality.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman.

A couple of questions. Mr. Seidman, in your testimony, you refer to the Arthur Andersen study but you do not spend much time in saying that the Arthur Andersen report seems to indicate that safe harbor has not had much effect on major investment plans.

Now, they do qualify that. "The survey indicates that safe harbor leasing has not been a significant one to date" with reference to a company's decision to make the investment. They say that is not surprising since the transactions surveyed involved equipment acquired before the safe harbor came in. But they also go on to say that while some companies get better cash positions, there is a strong indication that these companies could have obtained funds elsewhere, although perhaps at a higher cost.

Then they go on to say there is little indication that if safe harbor leasing were repealed, this would trigger a greater interest in mergers and acquisitions, another point that was raised in testimony.

How do you square that with your feeling?

Mr. SEIDMAN. First, sir, my views, of course, are importantly influenced by our own industry and our own experience, and I can say that our experience, like that of the other gentlemen at this table, is that a large part, if not all, of these investments which we have been discussing in these industries simply would not be made without the safe harbor leasing.

At the time the survey was made, safe harbor leasing was just really becoming well known, and the effect of it, so I can only answer that it is clear, at least in the industries and the companies represented at this table, that if the safe harbor leasing were not available, the capital spending would be reduced.

In the case of our own company I think it is quite clear that it is really the basic source of these funds and they are not available from other sources in our present position.

Mr. JAICKS. Mr. Stark, if I might add a point to that, I think whether or not alternative sources of funds are available is not really the total answer to the question, and I guess we have some sensitivity in that area right now in that funds are available in the steel company but as of 2 years ago they were available at AA ratings, last year they were available at A ratings, and as of 2 weeks ago, BBB plus. So the added cost of borrowing at a BBB rating changes the ROA on that tremendously, even if the funds are available.

Mr. STARK. However, you could cut out $30 billion. That is what safe harbor is costing us in addition to accelerated cost recovery, $30 billion from this, $30 billion from defense, $30 billion someplace else. I could knock that deficit out of the box and I would probably drop prime from 16 to 12, and I submit that that does you the same benefit, and not only does it benefit you, it helps in California, which is the service industry. Well, not really, they are capital intensive in California.

So quite frankly, from a parochial standpoint you guys do not do much for the service industries and the high tech industries if I want to be very selfish about it. In other words, what kind of a cut do I give the Clorox Corp. that pays about 50 percent of their income in taxes because it is really selling a household product. They are not capital intensive.

So you are cutting a fatter hog, in a sense, as a capital-intensive industry. It is very difficult for someone who wants to promote high tech and service industries to explain why I am giving it away, and that is a political problem and, I suppose, a regional problem.

Mr. JAICKS. If I might add, cutting a fat hog is a bit of a narrow view in that all of these funds that come in are going to be used for profitable, employment, competitive, productivity gains.

Mr. STARK. Buying Marathon Oil was nothing more than a tax scam on the part of U.S. Steel. That does not produce any steel and doesn't create any jobs, and when you take Mobil Oil buying Montgomery Ward, that does not sell. I am sorry. It is the profitable steel companies that invest.

Let me go to Mr. Dickey on another subject because I think you brought up the merger question, didn't you, in your testimony?

Mr. DICKEY. I am not sure if I commented on it or not, but I am quite prepared to.

Mr. SEIDMAN. That was my testimony, Congressman.

Mr. STARK. Do you think that we should perhaps pass some legislation that would say, knock out the interest deduction for borrowing, for leverage buy outs? Would that be a way to prevent some of what I think are economically useless mergers that are mostly done to get a higher basis on a bunch of assets, to let the tax code or the taxpayers pay for takeovers? Do you think that maybe there is an area in this whole question of megamergers that this country ought to look at?

Mr. SEIDMAN. Sir, that is a huge question, in which I am certainly not qualified to give you any more than perhaps a not too well thought out opinion at this point. I think that the Congress ought to be careful that they do not create incentives for those mergers, and as I pointed out in my testimony, without safe harbor leasing, there are very large incentives for that kind of thing to happen. So, overall, I think that mergers that are based on tax considerations are not likely to be good for the economy in the long run. So, I think it is a problem, but I do think that the safe harbor leasing addresses it in a way that at least helps to prevent that kind of acquisition.

Mr. DICKEY. I might just make one comment, and this is really a totally different subject, but in response to your question, if you did what you propose, really what it would do would be to enhance the possibility of foreign companies buying out U.S. companies.

Mr. STARK. What you are saying is, if we restrict the deductibility, we would create an open season for companies who could borrow off-shore to come in. Are most of the foreign takeovers financed off-shore, or are they financed by our own banks?

Mr. DICKEY. I honestly do not know.

Mr. STARK. I do not know that, either. That is a point well taken. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Brodhead will inquire.

Mr. BRODHEAD. Thank you, Mr. Chairman.

Mr. Penick, you have an interesting study here of the efficiency of the safe harbor leasing. One of the proposals that has been made over the years for dealing with the problem of the loss company which is making investments would be to make the investment tax credit refundable. Would that not be more efficient?

Mr. PENICK. The refundable credit obviously has been suggested before. As far as it goes, it might do part of the job, but you have to recognize that safe habor leasing involves not only the investment tax credit, but it also involves the benefits from the accelerated cost recovery which a refundable tax credit would not do. Whether it is more efficient, I do not have any personal view on that one.

As of now, the values——

Mr. BRODHEAD. Clearly, some part of the benefit of this provision goes to the company that is purchasing the assets in question. Otherwise, they would not do it. If there were not profit in it for them, they would not be doing it, right?

Mr. PENICK. That is correct.

Mr. BRODHEAD. There is no one entering into this on the basis of giving money away, is there?

Mr. PENICK. Not that I know of.

Mr. BRODHEAD. So what you have then is profitable companies making even more profit off of this provision. Do you not?

Mr. PENICK. They are making some profit. How much they are making is arguable, based upon our survey. They are looking on this as purely an investment. They are analyzing the transactions in that fashion. Clearly, they are making some profit. Otherwise, they would not do it. Now, the question, I think, is, is it better for the marketplace or whatever you want to call it to really let the buyers who have the funds and the sellers who have the assets that they need to finance, let them negotiate what is a fair price, or should you take that completely out of that arena and have a more limited sort of an incentive for investment for loss companies through a refundable credit.

It could be done either way, except the refundable credit, as I say, does not go as far. It does not consider the tax benefits from accelerated cost recovery.

Mr. JAICKS. In fact, as a general statement, it only goes about half as far. Generally, about half and half of the safe harbor lease benefits to a seller relate to the ITC, and the other half to the accelerated depreciation, Mr. Brodhead.

Mr. BRODHEAD. In the case of your company, Mr. Jaicks, if, for example, last year, in 1981, the ITC had been refundable, what would you have gotten out of that, versus what you have gotten out of the safe harbor leasing?

Mr. JAICKS. I would have to calculate it on the $71 million, and I would be glad to supply the information, sir. I am guessing that about that split I mentioned, of the $19 million plus that we did get it, roughly half of it would have come in through refundability, but I can get you a more accurate reading on that, and I will.

Mr. BRODHEAD. Mr. Tippett, what is your view on this?

Mr. TIPPETT. Well, I think, as expressed, the refundable investment tax credit would only address part of the problem. In other words, in the case I gave of the Toledo paint shop investment, where we got $10 million for a $30 million investment, oversimplified, we would only get 10 percent of $30 million or $3 million back from the refundable investment tax credit, leaving us $7 million short of what safe habor provided us. So, unless there were a way to include the value of the depreciation in the transaction on top of the investment tax credit, it would not be as attractive. If there were a way to do that, it would in fact exclude the third man from the table, and could be a simpler way to handle it.

Mr. BRODHEAD. I guess that is what bothers a lot of people. I do not think—at least it does not bother me—that loss companies which are temporarily incurring losses but yet are continuing to make substantial investments, that the law would attempt to put them on some sort of an equal basis with other companies. That is a rather sound principle. I guess what bothers a lot of people and bothers me is that companies which are profitable and really ought not to be getting special tax breaks are getting, to some degree, tax breaks out of this. There is a great deal of dispute about how much that is. I think our joint committee says it is somewhere around 80 percent of the benefit goes to the loss companies. The Treasury says—I have forgotten. Mr. Penick had that in his testimony.

Mr. PENICK. Theirs was 84.

Mr. BRODHEAD. I think our joint committee was 78, wasn't it?

Mr. PENICK. Seventy-six. I am not real sure, since I have not seen the report.

Mr. BRODHEAD. And your range is somewhere in the nineties.

Mr. PENICK. It averages out to about 90.

Mr. BRODHEAD. In any case, I think that this is what is bothersome about it. At a time when our Government is running these huge deficits, that we have to watch our pennies, I think we need to begin to watch on the spending side, and I think we need to watch on the tax break side, and provide tax breaks to companies that are making critical investments and need to stay in business. But why provide benefits, extra added benefits over and above the benefits that we are giving in ACRS to profitable companies? I think that is the question that is disturbing to many of us.

Does anyone want to respond to that? Mr. Seidman, do you have a view on that?

Mr. SEIDMAN. Yes, sir, I would like to make this comment. In effect, these companies are administering this, prior to the law, the Government is trying to have the Treasury try to determine the values of each of these deductions and arrive at some kind of a payment. I think the reason the Treasury chose this is largely involved with the fact that they thought it was a more efficient way to operate, and that 90 percent, let's say, of the values would go to those they were trying to help. So I think that politically I can understand that this may be difficult, and you would know more about it than I do, but in fact the purchasers are the ones who are seeing that these provisions are operating on a marketplace, businesslike basis.

Mr. BRODHEAD. Thank you.

Thank you, Mr. Chairman.

Mr. TIPPETT. Congressman Brodhead, if I could say one more thing, we seem to be focusing excessively here on the companies themselves as if it was in effect a subsidy, when in fact the safe harbor leasing applies only to legitimate, economically justified investments which in 99 percent of the cases provide jobs, and the best way to reduce the tax deficit, or one of the best ways, would seem to be to reduce our unemployment levels in this country, and we will not be in a position to do that in our industries which are generally very high employment industries until we get fully competitive on a world basis, and this kind of investment is going to create jobs, and that is one of the things I think we probably should focus on more in these discussions.

Mr. BRODHEAD. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. Thank you, Mr. Chairman.

I do not really have any questions. I do think that one thing must be considered on safe harbor leasing, and that is that every cent that is invested in tax reduction by the transferee of the unused tax credits goes into capital investment. That was the purpose of ACRS and that was the purpose of the tax bill. It was an effort to spread corporate tax reduction beyond the capital intensive profitable company that could take advantage of new tax credits created in the interest of capital investment.

A service company in California can participate in this corporate reduction. They could not benefit from ACRS if they were not making any capital investments otherwise. An unprofitable company could benefit from a corporate tax reduction of this sort by getting the current value of the depreciation and investment tax credits deferred through a comparatively open, negotiated process.

It does provide a degree of regional benefit also, because it provides tax reduction generally through this transfer process to the northeast, which otherwise would not be able to benefit a great deal from accelerated depreciation.

I hope people will understand also that to a very substantial degree this achieves the goal of Professor Jorgensen's theory of current value depreciation, front end depreciation. That was something that liberals were espousing here at the time that 10-5-3 was enacted. This, of course, is going to be true and achievable only if tax credits are permitted to achieve their economic value. If we have a high risk situation, whether by unilateral decree emanating from Kansas or by uncertainties which result from administration decisions relative to the minimum tax, then the whole issue becomes, obviously, a failed issue. People are going to be able to buy in a buyer's market tax credits below their tax value and below their economic value. Therefore they get a disproportionate tax reduction that they are not entitled to by virtue of the risk element involved in the purchase.

That means we have to do something. We cannot leave it the way it is. But I hope we can do something that will permit companies like yours, with very heavy capital needs, if they are ever going to dig out, to get some benefit from the corporate tax reductions that we enacted last year. In other words, it is not the best of possible worlds. The question is, how do we salvage something at

this point, which is part of the philosophical underpinning of the Economic Recovery Tax Act, and which is absolutely essential if we are going to get the full benefit of the tax reductions that were contemplated last year.

If any of you have anything you would like to say other than amen——

Mr. BORMAN. I wanted to say amen.

Mr. CONABLE. Thank you. Thank you very much. Reverend Conable closes the prayer at this point. [Laughter.]

Mr. PEASE. Reverend Conable also prompts his audience for the response.

Thank you, Mr. Chairman.

I think I have only one question, that is, relating to the curbing of what some people call abuses, or at least what has shown up in the newspapers as abuses, which have given safe harbor leasing a bad name. I think it was Mr. Tippett or Mr. Borman, one of the two, who suggested putting a cap on the percentage of a company's profits that could be offset against safe harbor leasing.

Mr. BORMAN. I think we all did, sir.

Mr. PEASE. I wonder if that would really do the job or not. If we put a cap on, and then the company used its own tax credits and depreciation and so on, would it not be possible for that company to reduce its profits down to zero and still generate the kind of newspaper headlines which tend to discredit this program?

Mr. SEIDMAN. Sir, if I might answer that, there are two different possible kinds of caps. One would be a percentage of the taxable tax he would have paid without it, and another one would simply be below a flat percentage of the income of the corporation. That is, let us say you could not reduce your taxes below 15 percent of your income.

Mr. PEASE. The latter would be in the nature of the corporate minimum tax that the President is proposing?

Mr. SEIDMAN. You might say it was in that nature, except that it would not deal with preferences. It would simply say that using this particular vehicle, so that if that were considered to be a problem, that kind of a cap would take care of it without essentially changing the nature.

Mr. TIPPETT. Or, for example, after reducing its profits by the amount of taxes the company itself would normally apply—let us say it came down to $50 million. Then the last thing to be applied would be tax credits from sale of leases of this tax, so that he would still pay $25 million, let's say, under a 50-percent-cap rule, so there are ways to prevent that from going to zero.

Mr. PEASE. If such a limitation were imposed or if this were tied in somehow with the corporate minimum tax proposals, do you think that that would seriously restrict the availability of purchasers of these tax credits?

Mr. SEIDMAN. First, I think the corporate minimum tax as now proposed will seriously restrict buyers. I do not think the kind of cap we are talking about—it will make it a little more favorable for the buyers, but it is our impression in the marketplace that there still would be sufficient buyers to get fair value for the tax benefits.

Mr. PEASE. Thank you very much, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Bailey will inquire.

Mr. BAILEY. Thank you very much, Mr. Chairman.

First of all, I want to compliment our chairman on that issue concerning giving you people an opportunity to come here and speak and present your views. I very much wish all of the members had been here, for this was one of the finest panel presentations we have had, certainly one of the most thorough and very objective and very honest.

I do agree, however, with the gentleman from Florida, Mr. Gibbons. I wish you had supported the expensing provision. Although the issue of effective tax rates, I realize, may not have been as helpful, it would have, I think, in the long run, been beneficial, but that is water over the dam. There was too much political energy in the system at that time.

I think you all know that I am a very strong supporter of this mechanism. In response to what the gentleman from Michigan said, if we can clean it up and resolve some of these difficulties surrounding a few of these myths and misperceptions, the one crucial aspect is, of course, the ability to transfer deductions which, incidentally, in some of the dollar amounts, really reflecting a top corporate effective tax rate of 46 percent are only worth 46 cents on the dollar.

Sometimes these things are presented as if the huge aggregate dollar amounts really exaggerate the amount of the transaction. I think it is important to get that disparity on the record. The gentleman from California is a dear friend of mine, and I am an admirer of his. He made some comments that I think really go to perhaps the heart of the matter.

Mr. Seidman, you had mentioned the generic difficulty that we have in the country with capital-intensive industries. The gentleman from American Motors had some comments about the Japanese system, for example, in writing things off. The country has got to respond, or, in a short few years—10, 15, 20 years—we are simply going to lose. Capacity, in basic capital-intensive industries, we are just not going to have it. That is really the choice we are going to have to make about our tax code, and how it impacts business and American national goals.

Those are things we are going to have to decide, because that Tax Code has not been neutral in the past.

On the cap, my question really is this: In response to what the gentleman from New York, Mr. Conable, said, if we could come up with a proposal on discount rate, could we still maintain a market for the transactions if we were to limit the discount rate to make it profitable for the transaction to take place, taking into account, of course, the minimal costs of the transaction, and perhaps, do you think we could dispel some of the doubt and some of the discord that way?

What I simply mean is this: Go along with the cap, because the people are going to talk about it—the General Electric situation. Incidentally, I think we all know that the issue is really how much of that benefit gets transferred to those individual companies or those industries specifically who have earned those benefits. That is really the issue. That is the cost issue. That is the policy issue.

The point is to structure the proposal in a way that decreases an excessive amount of profit, an excessive amount of advantage to that third party, who is reducing their tax liability disproportionately in the eyes of the public. Do you think we can maintain a market out there if we can get up into that 90-percent-plus range, maybe cap out at 50 percent or so, and maintain the flow of this money for investment purposes to this Nation's very vital and necessary industries?

Can we do that above 90 percent? Can some of you speculate on that?

Mr. SEIDMAN. Sir, I think that the most effective way to get the maximum transfer is to let the marketplace set the price and create as many buyers as you can.

Mr. BAILEY. Where would it settle out?

Mr. SEIDMAN. Our own calculations, and of course we make them—we are sellers in this transaction—is that we are getting about 90 percent of what we estimate to be the value of these tax credits.

Mr. BAILEY. Let me interrupt you at that point, because there is something that people may not understand. Many industries and many companies in your position also derive a cash flow benefit, do they not, from that up front?

Mr. SEIDMAN. Yes.

Mr. BORMAN. It is enormous.

Mr. BAILEY. Well, members here may not understand what that means, and what it means to you in terms of present benefit or advantage, so before my time expires, I would like you to comment on that issue. Some of you may have been present when I testified before the Senate Finance Committee on this issue. Incidentally, I have talked with the union people, and I share some of their views. I want you to know that they do not object to some modifications provided that modifications are made to make sure that the right people get the money.

Cash flow—a comment on that: Have you done any studies on job implications, spinoffs? You know, you are great purchasers of capital goods. It is not just the job in the plant. It is the jobs that we gain by virtue of the tangential purchases that you make.

Could you comment on those two things? The advantages to you are not understood.

Mr. SEIDMAN. I can comment certainly with respect to our company and our industry. As far as cash flow is concerned, we are receiving something in the nature of 35 percent of the total cost, 30 to 35 percent of the total cost of the equipment that we are purchasing. That cash flow is immediately reinvested by us in additional capital spending, and it is very clear in our case, and I think in every case around this table, that that 35 percent would not be available in almost every case unless we received it under the safe harbor leasing.

So, our cash flow is increased by one-third of what we spend.

Mr. BAILEY. My time is up, but what you are really saying is that you could not make that investment because you have nowhere else to go in order to finance it. This is vital in that regard. It is not very well understood when we are talking about the value of these transactions.

Mr. JAICKS. There are two elements in terms of the investment process, Mr. Bailey. One of them is, if you get a 25-, 30-percent discount, if you will, in the cost of that capital investment, your ROI is better. Second, the cash flow implication says there is more money available to do more projects.

Mr. BAILEY. I thank you.

Chairman ROSTENKOWSKI. Mr. Moore will inquire.

Mr. Frenzel.

Mr. FRENZEL. I thank the panel for their testimony and I have no questions.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

I would like, with the chairman's permission, to submit for the record a letter that I received on February 22, 1982, from the plant manager of Phelps Dodge, which is located in Fordyce, Ark., which is in my district. This letter substantiates in more detail what the chairman of the board has indicated, and specifically talks about. That of their total savings, $1.7 million of that was directly attributed to property located in Arkansas. I think it would be instructive for the record and for the committee to have this example.

Mr. Chairman, could I gain permission?

Chairman ROSTENKOWSKI. Without objection, it is so ordered.

Mr. ANTHONY. Thank you.

[The letter referred to follows:]

PHELPS DODGE COMMUNICATIONS CO.,
Fordyce, Ark., February 22, 1982.

Hon. BERYL ANTHONY, Jr.,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. ANTHONY: As you know, Phelps Dodge Corporation operates a Telephone Cable Plant at Fordyce. This facility makes a significant contribution to the economy of the surrounding area and to the State of Arkansas. It is in light of this contribution that we feel it is important to report to you concerning our utilization of the safe harbor leasing provision enacted by Congress last year, and to urge you to support this critical element of the 1981 tax package.

During 1981, Phelps Dodge invested $147.1 million in new capital expenditures. Of this amount, approximately $76.9 million qualified under the so-called safe harbor leasing provision contained in section 168 (f) (8), which was added to the tax code by Public Law 97-34, The Economic Recovery Tax Act of 1981. In November and December of last year we entered into two transactions through which we transferred the tax benefits associated with substantially all the qualifying property placed in service in 1981 to a third party pursuant to safe harbor leases. These two transactions provided Phelps Dodge approximately $22 million in cash—$1.7 million of which was directly attributable to property located in Arkansas.

All the funds generated from these transactions will be used to finance capital expenditures which otherwise would have been postponed, or perhaps never made at all. These capital expenditures are critical if we are to maintain and expand our operations, and comply with government-mandated clean air standards. Assuming we have sufficient funds, we anticipate our qualifying capital expenditures in Arkansas will total $2.2 million in 1982. Also, we have budgeted an additional $5.3 million in capital expenditures in Arkansas over the period from 1983 to 1986. Without safe harbor leasing or some comparable provision, it is clear that a substantial portion of these expenditures will not be made.

In our judgment, safe harbor leasing is not an unintended loophole which should be repealed. We believe the provision is an essential ingredient in the President's economic recovery program. The Accelerated Cost Recovery System which was incorporated in the 1981 Act and the investment tax credit are of value to companies with enough taxable income against which the credits and deductions can be applied. But they are of little value to companies, such as Phelps Dodge, that because

of low earnings, are excluded from using the provisions in the tax code which are vital to capital formation.

Safe harbor leasing is particularly beneficial to industries currently in a cyclical downturn and most in need of cash flow for capital investment—such as mining, steel, automobile and transportation. Were safe harbor leasing repealed, the Economic Recovery Tax Act would unfairly favor profitable companies and would result in a misallocation of the nation's capital resources.

The safe harbor leasing rules are not perfect. Certain changes in these rules would simplify some of the mechanical problems which have arisen in implementing transactions pursuant to the provisions, and modifications of the rules may be necessary to eliminate or reduce some of the unintended benefits which have arisen. However, we strongly support the basic concept embodied in the safe harbor leasing provision, and believe that it should not be repealed.

Undoubtedly there will be many suggestions made to change the safe harbor leasing rules. It is our hope that you will carefully study these measures and resist those that would have the result of excluding major segments of American industry from participating in the economic recovery program.

Sincerely,

A. B. RACKELIN, Jr.,
Plant Manager.

Mr. ANTHONY. I think it has become very clear from listening to the panelists and also from the questions that have been asked that we can, with two very simple amendments, correct the most serious problem. I think that we can amend it to apply the safe harbor leasing provisions before applying the foreign tax credit. That will take care of that problem. You will not have another Occidental Petroleum hitting the front page of the business section.

We can also take the carryback provision and we can put a cap on the use of the leasing provisions for any one year to a reduction of 50 percent of the tax liability of that year, be it 50 percent or some other percentage. But again, we do not get into the situation where General Electric utilizes all of its safe harbor leases and then uses carryback to get a net drain back out of the Treasury, to the extent that it looks bad publicly.

But more particularly, I would like to read to you from a comment, a statement that has been prepared by Congressman Tom Daschle from South Dakota, and then I want to close my comment with one question. This goes to tax neutrality. It goes to tax policy. It goes to equity. It goes to rolling back up the snowball that Mr. Conable talked about. It talks about political problems back in your district, and what we can do about the mounting deficit. I just want to quote from part of his testimony.

General Electric has reduced its federal income tax by $107 million compared to the previous year. General Electric, with pretax earnings of $2.66 billion last year, has reduced its 1981 federal income tax payment to an estimated $60 million, an effective tax rate of 2.25 percent, and will claim a tax refund of $150 million for prior years.

Now here is the kicker:

Not only in South Dakota but in every congressional district in the United States: in comparison, a South Dakota couple with $23,270 in taxable income last year filing a joint return will be paying $4,082 in federal taxes, according to the IRS. This is an effective tax rate of 17.5 percent.

He calls for at least the tax loophole being closed. It either needs to be closed or modified.

But when you talk about tax neutrality among corporations, you also have to talk about tax neutrality among businesses and individuals. My last question.

What, if anything, is business willing to give up in order to help narrow the tremendous deficits the country is staring in the face? I would like to have each one of the panelists respond.

Mr. DICKEY. Let me take a crack at saying something in response to your question, Mr. Anthony. As you think back over the last decade or certainly over the last 5 or 6 years, one thing that I think the Congress has agreed on, the majority of the people in the country were agreed on and the people in business were agreed on was the need to do something about capital formation. Capital formation is really just another way of saying capital expenditures in investment and plant.

As a result of that concern, there emerged the Accelerated Cost Recovery Act, which I think had the support of most everyone. But the thing that was missing in the Accelerated Cost Recovery Act was the ability to provide capital investment for the kinds of industries you are looking at at this table. And those are the ones that most people had in mind when they were concerned about capital formation.

Mr. Bailey asked about the number of jobs. There is no way that we can pinpoint the number of jobs. But certainly on the construction jobs that we are involved in, there are a great many people on those jobs. There are a great many people involved in supplying the equipment that goes on those jobs.

Mr. Stark talked about the fact that there were not too many capital-intensive businesses in California. But if you look at the customers of companies that are probably in his district, you will probably find that a great many of the companies that are represented at this table are very big customers of those companies, and they are customers in the form of things that are going into the capital projects that we are building today.

Now the thing that bothers me the most is the concept that this is a giveaway to a number of people to reduce their taxes. Really what those people are doing is they are making an investment. Instead of paying taxes, they are making an investment in American industry. And that investment multiplies itself considerably in terms of the advantage to the capital-intensive businesses, because for every dollar of investment that let us say a General Electric or anybody else is making instead of paying taxes, that is contributing at least $5 or $6 to capital projects. And if the deficit problem is going to be cured, certainly the best way that that deficit problem is ever going to be cured is to revive capital-intensive businesses in this country.

Mr. ANTHONY. I could not agree with your comment more, and since my time has expired, Mr. Chairman, I would ask permission that the panelists be permitted to respond to that question in writing for the record if you desire. I am not making it a direct demand from me, but if you have some additional comments that you would like to place in the record please feel free to do so.

As I perceive it, we have a political problem, and that is how to balance out this problem that we have between individuals and business, and I would like you to share your expertise with the committee.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you.

I would just like to know from the panelists individually if you had an option of having the corporate income tax be eliminated or safe harbor leasing and the ITC removed, which you would prefer.

Mr. BORMAN. Could you repeat that, sir? I could not hear you. I am sorry.

Mr. DOWNEY. The question is, if you had the alternative of having the corporate income tax repealed or safe harbor leasing and the investment tax credit, which would you prefer?

Mr. BORMAN. I would prefer the safe harbor leasing, without question.

Mr. DOWNEY. Mr. Tippett?

Mr. TIPPETT. I think in our current mode, we prefer the safe harbor leasing, obviously, but I think these industries need the investment now. And of course the repeal of the corporate income tax would not benefit us in any significant way at this point. We need the help now. We do not need it in 1985.

Mr. JAICKS. I agree.

Mr. DICKEY. I agree for the same reasons.

Mr. DOWNEY. The consensus then of the entire panel, if you had the choice of eliminating the corporate income tax, the safe harbor leasing and ITC, you would all prefer to have the corporate income tax and keep safe harbor leasing?

Mr. JAICKS. I would say that you are reaching us at a point in time here, and the reason that we are before you is because of a specific situation which in many cases has resulted from the fact that we have not had a very good depreciation policy in our tax law, and we have been undergoing very high inflation rates, and that is one of the main reasons why you find many of the companies who have representatives here today in this tax loss position.

We all expect to be taxpayers. I am sure of that, one of these days. That is the reason we want to do the modernization work. I submit that in my case, I might change my view when that circumstance arrives.

Mr. DOWNEY. Do the members of the panel think that it is good tax policy or bad tax policy to have what in effect amounts to negative rates of taxation on certain corporations? Is that good or bad tax policy?

Mr. BORMAN. I am sorry. I have a hard time hearing you, sir.

Mr. DOWNEY. I am not sure the microphone is working. Is it good or bad tax policy to have in effect negative rates of taxation on certain corporations?

Mr. BORMAN. I think in this case, speaking from the standpoint of the people represented on this panel, it is good tax policy and I happen to believe it is good for the country. It does more, safe harbor leasing does more to keep the playing field level among the various corporations, than any other device that we have seen. And if you do not have some degree of leveling function, you are going to end up with an enormous imbalance.

Mr. DOWNEY. Mr. Borman, let me ask you a followup question. Is the tax code the place to do this? Is there any other form that conceivably could be done more efficiently than to do this through the tax code?

Mr. BORMAN. Well, you are going to have to do it through the tax code one way or the other, in the final analysis. I would prefer

to do it through safe harbor leasing, with a market relatively unrestricted from the standpoint of the buyers, rather than through refundability.

Mr. DOWNEY. OK. Mr. Felix Rohatyn and others have suggested, and in a book that I am in the process of reading—I have not even completed it—Robert Wright and Maxiner suggest that somehow there is another forum for providing capital, and it has been suggested here, that we have investment banks or a national investment bank to provide this capital, to make strategic decisions as to what industries we want to help with capital and which ones we do not.

Does not safe harbor leasing in effect reward everyone who is in a position to use it, when it might not be in the national interest to have all of those corporations be rewarded? I mean it may be in my interest since I fly the shuttle every week to make sure that Eastern is kept with a playing field, but what bothers me is it seems to me that there are corporations that are going to profit from this or use it, that if we had a national industrial policy we might not want them to be able to use it.

What I am suggesting to you is that there is another mechanism to keep the playing field level that is not as inefficient or as expensive as the tax code. I would like your comment on that.

Mr. BORMAN. Yes, sir. I strongly disagree with that. I think that there is a tremendous temptation among human beings to think that they are smart enough to plan an economy as complex as ours, and I think that the experience in Western Europe has shown that that does not exist.

Mr. DOWNEY. Well, I do not disagree with that notion. Communism and central planning is failing all over the globe. I think that is obvious. But I think if you take a look at what Miti does in Japan, for instance, and if you modeled something along those lines, that they have been intrusive, but it seems to me that the results have been effective. Would you comment on that?

Mr. BORMAN. Sir, you are on a philosophical level here. I would like to talk to you about a practical level. I made a billion dollar decision based upon a law that was endorsed by the Congress and signed by the President in August. Six months later, that is in jeopardy. I am really not nearly as much concerned about how the Japanese run their industry as I am getting that law reaffirmed.

Mr. TIPPETT. I might add to that, it is not really in jeopardy. The law has been in the real world repealed 6 months later because the market has dried up. We are getting jerked around. We are trying to do the planning we need to do to run these businesses, and 6 months later the market has dried up.

Mr. DOWNEY. You see, from our perspective, and I do want to wax philosophical with you for a moment, because we have to make some decisions as to whether or not we are going to keep this or not, and I would prefer to stop providing band-aids to a very sick economy, or even large sutures. At some point we are going to have to wax philosophical and at some point we are going to have to make a decision as to what makes sense. Is it to subsidize corporations that we want to keep, with capital needs, through a tax mechanism or not through a tax mechanism.

So it is very much germane to your practical daily question and to my consideration of what I want to do.

Chairman ROSTENKOWSKI. Mr. Schulze will inquire.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. Chairman, I would like to take this opportunity first to welcome Mr. Dickey to the panel, as well as the other distinguished members of the panel. Mr. Dickey is a well-known member of the business community in southeastern Pennsylvania, and Scott Paper is an exemplary example of a good corporate citizen in that area. We are happy to have you here, Charlie.

Mr. DICKEY. Thank you, Mr. Schulze.

Mr. SCHULZE. I guess I would first like to state that I agree with what seems to be the consensus of the panel that criticism of safe harbor leasing has been more of a media event, and time has not been taken to look behind the scenes. It has been rather an emotional tone in which it has been discussed, and sort of inflammatory.

In the last tax bill we passed, the business community got about 22 percent of the benefit of that bill, which was much lower than the historic ratio of benefit that the business community has derived in the past. And safe harbor leasing was a very important portion of that measure.

It seems to me the question is, is it accomplishing what it was designed to accomplish? That was to stimulate or increase economic activity.

I would have to assume that all of you gentlemen agree that it has accomplished that. Does anyone disagree with that?

[No response.]

Mr. SCHULZE. As I came back into the room, I heard the tail end of a response to Mr. Bailey's question. I do not know whether it was similar to a question I intend to ask, and that is: I looked over the Andersen study but I did not see any figures on employment. Is there any way that we can get a feel for whether this has either increased employment or whether it has reduced the potential of unemployment? Does anybody have any kind of response to that?

Mr. PENICK. Our study obviously did not go that far. We did have some statistics on the number of employees of the companies included in the survey, but we really could not respond to that.

Mr. SCHULZE. Does anyone have any, from their personal experience, any kind of a seat of the trousers response?

Mr. BORMAN. The airline industry has about 10-percent unemployment now and I can assure you, as I mentioned earlier, United has put on hold an order of a billion dollars worth of airplanes; American has canceled $1 billion; we have in jeopardy a billion dollars worth of airplanes. And I can assure you that the potential for unemployment in Boeing, in the aircraft industry, and there are thousands of subcontractors, is enormous. That is not directly in the airline industry itself, but we are already severely impacted, with about 10 percent of our former employees unemployed.

Mr. SCHULZE. It seems to me that those who have taken advantage of this opportunity have been the industries which we do designate as distressed, and that the layoffs would have been much larger without having had this opportunity.

I was therefore somewhat shocked when AFL–CIO testified in opposition to safe harbor leasing yesterday. I think that if you could generate figures on employment, it would be a fairly important portion of the argument for retention.

Mr. PENICK. Mr. Schulze, of the companies that we surveyed, and on page 11 of our report, we did find that about 8.3 percent of their employees were laid off, which does not really respond to your question, but nevertheless, this group of companies was pretty much in the ball park.

Mr. SCHULZE. I saw that figure. I also think that what we are doing is talking about providing the capital for the opportunity to increase productivity, and therefore increase employment, sales, the whole ripple effect. And what we are doing is to help the industries which have often been impacted by external influences beyond their control—foreign imports and other areas which have caused their distress.

Therefore, I think that from what I have seen, safe harbor leasing is accomplishing that which we set out to accomplish, and I would hope that even if in this charged political atmosphere we have to tinker a little bit, that we do not throw the baby out with the bathwater, as we go through our deliberations.

Mr. Dickey, I had intended to ask you about the February 19 date and how that has caused you problems. Do you have anything to add? I know that it has been discussed.

Mr. DICKEY. I do not mean this to be facetious, but my horoscope—there must be something funny about February 19 because twice it has come up as a very bad day. Representative Conable and I, on February 19, 1945, went ashore at a place called Iwo Jima, and February 19, 1982, also proved to be a bad day.

Mr. SCHULZE. You had the same emotion in both cases? [Laughter.]

Mr. DICKEY. In answer to your question, it really has dried up the possibility of making leases. It is not totally impossible, but it puts the lessor at a great advantage and the lessee at a great disadvantage.

Mr. PICKLE [presiding]. Mr. Gephardt will inquire.

Mr. GEPHARDT. Thank you, Mr. Chairman.

Could you comment on your view of safe harbor leasing as opposed to a refundable investment tax credit? Mr. Borman, you said before that you preferred safe harbor leasing to the refundable credit. Could you tell me why?

Mr. BORMAN. Yes, sir. For two reasons. The first one is that if you do not include accelerated depreciation in refundability, then you have still left the playing field inordinately unlevel. And I think that that would be very difficult to do.

The second reason is that I think perhaps the most effective way of accomplishing this is the free market. As long as you do not put too many constraints on the buyers, I think that the economic benefits will flow very equitably, more equitably than they might if you had refundability.

Mr. GEPHARDT. But would you not agree that if there was a way, and I do not know that there is, but if there were a way to make the playing field level by directing the benefits you cannot now receive directly to the corporation that was not paying taxes, rather

than going through this leasing operation, that we would get a more efficient use of the subsidy?

Mr. BORMAN. Certainly safe harbor leasing is far more efficient than leverage leasing. You perhaps were not here earlier. Leverage leasing is not even close to safe harbor leasing.

Mr. GEPHARDT. I understand that.

Mr. BORMAN. In any event, you are going to require some payment for the services provided in directing this, and I am content to pay that through safe harbor leasing. You may be able to devise some way within the Government to do it more effectively, but it has been my experience that the free market has provided the most effective means.

Mr. PENICK. Mr. Gephardt, I would like to expand on that slightly. We are concerned, all of us, I know, about the underground economy and the huge problems that the Revenue Service has in enforcing the existing laws. If you have a refundable credit of any type, and whether it is limited to the investment credit or perhaps factors in the cost recovery deductions, in essence, the Service will have to monitor compliance with whatever the rules are.

In safe harbor leasing, the lessors, the people putting up the money, I can assure you, are going to make sure the investment that is in place qualifies, that it is proper, and in essence they are going to be sure of what they are getting before they put out the money.

Mr. SEIDMAN. If I could just comment on that, each of these credits can have a different value, based upon the length of life, the kind of asset, whether there is an energy credit. They have different values and the marketplace does determine that. The purchaser evaluates that.

If you were to try to make it level across the board through the Treasury, you would have to have the Treasury evaluating each of these leases in the same way that the lessor does. That is why I stated previously that the 10 percent that the purchaser is receiving, as generally estimated is probably a fair payment for service, and the service is being done I think in a more effective way than it could be done by the Treasury Department.

Mr. GEPHARDT. Well, the reason I ask it is because, Mr. Seidman, your testimony said that Arthur Andersen's study, concludes that 95 percent of the benefits go through. The Treasury study apparently indicates 84 percent go through. If I read the paper the other day correctly, I think the Joint Tax Committee had a study that was less than 84; it was down in the 70's somewhere.

If we conclude that we are getting in the 80 range, it means we are losing in the middle between 10 and 20 percent or 25 percent of the money that we are trying to get to the distressed corporations. And I am just wondering if we believe this is an important thing to do, if we would not want to try to do it as efficiently as possible because maybe it would cost the Government less and you would get the same amount of benefit.

Mr. SEIDMAN. If I could just comment, we have not seen the Joint Committee report, but we understand that it is based on the assumption that these corporations will never be profitable, and therefore would never be able to use these credits. I think that as-

sumption clearly is erroneous, and that therefore changes the values.

So I think if we are going to average the values of the reports we now have, that 90 percent would probably be a fairly accurate estimate of what is going to these corporations.

Mr. TIPPETT. I think there is one other point, Mr. Gephardt, that these studies were done early in the game, before frankly the sellers got as expert as they now are in consummating these transactions. It would be my judgment if a study were done let us say—if the issue is revived here—that you will see a much higher percentage of the benefits flowing through to the investor than those studies indicated. I think the market is now much more orderly, and we understand what they are worth, so I think you would see the number go up in the 70's to the 90's. And that of course if what some of our experience has been.

Mr. GEPHARDT. Well, I appreciate you all being here. I certainly understand the frustration with a law being passed and then being taken away within six months. That is not my idea of giving business the stability and predictability I think that it needs. But I guess you understand that we have to go back through this whole thing, both philosophically, conceptually and practically. And I think our committee is going to have to go through that process, whether we want to or not, think it through conceptually, whether or not we want to continue to do this or want to do it in the future and then how best to do it.

I appreciate you testifying and giving us the benefit of your thoughts.

Mr. TIPPETT. I think the one thing you could do would be to make clear that whatever changes you choose to make would be made prospectively and not retroactively. Operating in the current climate is impossible, and to make retroactive propositions of a somewhat vague nature just completely destroys our ability to plan, forecast and operate in the market.

Mr. JAICKS. One other thought on that subject, Mr. Gephardt. My recall says that when the administration came forward last year with its business program, it actually, when the safe harbor leasing element came up, there were some other business programs that were considered which were withdrawn in order not to overdue what they thought was the max.

So I guess my plea simply is that whatever is done in the area of business tax changes ought to be done evenhandedly, and not just working on this one element, which, while it has high media exposure, cuts to a narrow but very important element of the business tax program.

Mr. GEPHARDT. Thank you.

Chairman ROSTENKOWSKI. Mr. Shannon will inquire.

Mr. SHANNON. Thank you, Mr. Chairman.

When the panel answered Mr. Downey's question as to which you would prefer, the elimination of the corporate tax or elimination of safe harbor leasing, everybody said that you would prefer to keep safe harbor leasing. I assume that is because none of your companies are paying corporate taxes. Is that correct?

Mr. DICKEY. It is not true in our case. We pay some corporate tax.

Mr. SHANNON. Federal corporate tax?

Mr. DICKEY. Some.

Mr. SHANNON. How much?

Mr. DICKEY. I cannot give you an exact number, but we are paying some.

Mr. SHANNON. OK, let me ask you all this. Should we not then extend the safe harbor leasing to include other non-tax-paying investors? Why should not a public utility, TVA or colleges and universities be able to take advantage of safe harbor leasing under the same theory? Mr. Borman, would you like to comment on that?

Mr. BORMAN. Well, I have been concerned most directly, and I am not sure if you were here when I talked about the 757 purchase, but I am concerned about competing in an industry where the playing ground is kept as level as possible. And in an industry where the effects of recession, deregulation and fuel costs have jeopardized the entire industry, I see nothing either in the American past or future that would suggest that a corporate income tax could be or should be eliminated.

On the other hand, I feel very strongly that safe harbor leasing does, and I am being redundant, does keep some level of competitive posture between the industries.

Mr. SHANNON. What you are saying is that you should get this incentive even though you are not paying taxes for whatever reason?

Mr. BORMAN. Either that or do away with it for all.

Mr. SHANNON. Because you are making the investments?

Mr. BORMAN. Yes. Either that or——

Mr. SHANNON. Should we not extend that theory to include other non-tax-paying investors?

Mr. BORMAN. We are a non-tax-paying entity not by choice. I will be the happiest person in the world when we can pay our full 46 percent. We are involved now, and we understand we are liable for tax and we will be happy to pay them when we get there. In order to get to that position, right now we need the same benefit as the people who are profitable in our industry.

Mr. SHANNON. But it is not really a tax incentive, is it?

Mr. BORMAN. From our standpoint, it is an investment incentive, and that is what it was designed to be.

Mr. SHANNON. It is a subsidy. It is an investment subsidy.

Mr. BORMAN. Subsidy, whatever you want. The concept of the investment tax credit is a subsidy or an incentive.

Mr. POLAN. Mr. Shannon, as most of the questions that have been asked and answered today do not really apply to the public sector participants in safe harbor leasing, and the one that you asked does apply, perhaps I should take a moment to respond.

Congress did make a decision last year to extend these benefits to one narrow segment of the public sector— public transit—because you realized that there was a need for capital investment in that area, and this was a viable mechanism to do it, and it has worked. I think you should look at it in other areas as well.

Mr. SHANNON. Colleges are having problems, too. Should we not extend it to the colleges?

Mr. POLAN. I cannot express a judgment on that. I think that is really your decision.

Mr. SHANNON. There is no philosophic objection to that from anybody?

Mr. SEIDMAN. Yes. I think there is a tremendous difference, Congressman. Let us take our case, where our company is competing against other companies which are automatically getting the benefit because they are owned by oil companies. So what you are trying to do in safe harbor leasing is to make the competition fair between us.

Mr. SHANNON. Why do you not sell out to an oil company and you will then be in the same position?

Mr. SEIDMAN. It is very possible that we will have to do that. If we do, it ought to be for good economic reasons, I would think, and not because the Congress——

Mr. SHANNON. Well, there are, but if we do away with safe harbor leasing, there might be some good economic reasons, I suppose.

Mr. SEIDMAN. Well, there might be others, but at least safe harbor leasing, in and of itself, is going to force decisions in that area which are not based on economic reasons but for tax reasons.

Mr. SHANNON. I guess what bothers me is this. I understand what you say when you come in and you say you need certainty in order to make investments. I think it is terrible that you have such an uncertain situation. I genuinely do feel that way. But I think we should know what we are talking about here. We are talking about Government conferring a benefit on businesses for making decisions which are not tax incentives, but it is a subsidy, and it is a kind of planning.

Several of you have mentioned how the free market works better than some kind of refundable tax credit, but I thought the free market said that in free enterprise, if you are not making a profit, you will not survive. And some of you are probably making profits, but some of you are not, and Government is stepping in and saying even though you are not making a profit, we are going to confer upon you this subsidy to keep you alive.

That is a kind of state planning. It seems to me what you are trying to do here is privatize profit and socialize loss.

Mr. BORMAN. If you feel that way, then I would suggest that you be against all investment tax credits——

Mr. SHANNON. I am. I am against the investment tax credit. I think we should have a neutral tax with no investment tax credit. I am for the repeal of the investment tax credit, and I am glad you agree with me on that because I think what we have now is a very uneven tax system that rewards the wrong types of activities. And as much as I am sympathetic to your problems, I just do not think Government should establish policies where we are going to step in and confer phony tax benefits upon nontaxpayers, as you are.

Mr. TIPPETT. Well, there are many nontaxpayers that receive Government benefits. If you are against food stamps and many other things of that type——

Mr. SHANNON. OK, that is right. But that is the point. This is like food stamps, is it not?

Mr. TIPPETT. No, it is not. We are creating jobs. These must be legitimate economic investments, or the people who are buying

them will not buy them. That is the best measure of their economic worth.

Mr. SHANNON. If you guys were making legitimate economic investments, you would not be in a loss situation today.

Mr. DICKEY. I really disagree with that.

Chairman ROSTENKOWSKI. Mr. Martin will inquire.

Mr. MARTIN. Thank you, Mr. Chairman and members of the committee.

Mr. Penick, in the survey which you have undertaken and which you have reported to the committee here this morning, it may be that earlier questions have gotten to the point that I am about to raise.

Did you discover or find anything in the order of what you would characterize as an abuse or inequity or unintended distortion of the marketplace by the safe harbor leasing provisions that were enacted last year?

You have given an excellent summary of the strengths, the advantages of it. For example, you have described a sort of big brother relationship that would not have been there had a refundable tax credit been provided to the mismanaged companies as well as to the well managed companies. Here you have said that buyers tend to evaluate the credit of the sellers and so forth. That is an advantage. But did you find any abuses?

Mr. PENICK. An abuse is I guess whatever it is in the eyes of the beholder, but the purpose of the survey was really to review these companies that were selected, try to see what their attitudes were and how safe harbor leasing was working for them, and not really for us to inject whatever our thoughts were.

Now having said that, I will give you my personal thought, which has nothing to do with the survey. The major perceived abuse clearly relates to the purchaser of the benefits, and we have talked about this a number of times this morning, the so-called General Electric transaction and things of that type, where companies have bought so many tax benefits that they not only have wiped out their current liabilities but have created carrybacks and refunds.

Even in those situations, those companies, the General Electric's, have provided funds for some of the companies sitting at the table here, to enable them to carry out their investment programs. The perception that that is an abuse is really a problem in itself. But as we have said again this morning, there are ways that that issue could be addressed, short of repealing the whole system.

Mr. MARTIN. Such as by limiting or making off limits the use of carryback for those who purchase tax benefits?

Mr. PENICK. That is correct. That or a percentage of tax liability or something like that.

Mr. MARTIN. Or by putting a limit on the amount that you could reduce your tax liability.

Mr. PENICK. Yes, sir.

Mr. MARTIN. You mentioned that most of them reduced it about 40 percent and that one reduced it 100 percent. Would 40 percent be a reasonable standard and do other members of the panel think that such a limit would arbitrarily prevent them from being able to do what they want to do? I believe the panel generally represents

sellers rather than buyers in the context of what you have described.

Mr. PENICK. Well, my view is that 50 percent has a nice sound to it and that could be a reasonable figure, but there is nothing scientific about that. I think that is a policy decision that you gentlemen have to make. Some of the others at the panel may have thoughts on it.

Mr. MARTIN. You found in your study that the sellers have been averaging about 95 cents on the dollar of tax benefits sold or leased. Another witness mentioned another study that found the average to be about 85 percent.

Would it be appropriate to try to legislate such a standard as a test of eligibility?

Mr. PENICK. I think that would be very difficult to do because in essence, you now have the free marketplace at work between the buyer and the seller. And the circumstances of the seller of the benefits, what kind of business he is in, its chances for the future, that can introduce an element of risk to the purchaser, so I think it would be very difficult for you to quantify that on a statutory percentage.

In our study, we did come out with a range of about 90 to 95 percent, and from what I have heard from some of the gentlemen at the table, that is fairly consistent with what they are getting now in the transactions they are carrying out.

Mr. MARTIN. If there could be some way found to legislate such a standard, say on the lower side of it, the 85-percent level, you do not forsee that that would adversely impact on the requirements of the sellers?

Mr. PENICK. In my personal view, it would not have a significant impact, but these gentlemen might be in a better position to judge that than I.

Mr. POLAN. Congressman, the various studies we have looked at relating to the value of the tax benefits and how they have been distributed, one of the real reasons why there is a difference in the outcome is the discount rate that you use to evaluate the value of future benefits. And it would seem a little illogical for the Congress to try to establish a discount rate through legislation. It kind of reminds me of that the Illinois legislature several years ago decided that they were going to legislate that pi should be equal to 3.14 for all time. It did not really work.

Mr. MARTIN. You are saying the difficulty of figuring out the present value of that discount rate would be very difficult to legislate?

Mr. POLAN. Right.

Mr. MARTIN. Well, Mr. Chairman, the red light precludes my next question. I yield.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. Thank you, Mr. Chairman.

The bottom line, from what I imagine we are talking about, is how we can help failing industries, and what our tax philosophy and social philosophy is, and whether or not these new concepts are in line with what our tradition is. And it seems to me that what we are really doing is taking well-to-do corporations and using them as surrogates to do what the Government could do and

has done in the past directly. We are going indirectly through corporations that are successful, to find a way to provide investment opportunities and subsidization for what was once the responsibility of the Federal Government.

I remember back, when a man by the name of Jesse Jones put together the Reconstruction Finance Corporation. Now there were a lot of failing industries in those days that were helped immeasurably, little known industries such as General Motors.

I am wondering whether or not you gentlemen will comment on whether you feel a corporation such as Eastern Airlines, Mr. Borman, could benefit from a Reconstruction Finance Corporation which would have the ability to give subsidies, long term low interest loans, and had the ability to give all the tax advantages if they are needed, to restructure totally a corporation and do what has worked so successfully in the past, because as I understand it, the Reconstruction Finance Corporation did not lose any money for our country and was able to put our industry back on its feet again.

This would be another attempt to solve the problem that we have today with companies such as Eastern Airlines and many other industries that are in trouble today, such as the steel and auto industries.

So I would like to know what your comments are as to whether or not this would be a better way of going, rather than going through safe harbor leasing.

Mr. BORMAN. Sir, I think that in the days of the Reconstruction Finance Corporation, we were in much more difficult economic times than we are today.

Mr. GUARINI. Our unemployment today is probably higher than at any time since the 1930's.

Mr. BORMAN. Since then, but in the 1930's it was over double what it is now. And I would strongly suggest that the timeliness required is to keep the safe harbor leasing. I do not think that the situation requires a Reconstruction Finance Corporation. I think we can avoid the requirement for that if you will simply keep in effect the tenets of what you enacted in August.

Mr. GUARINI. Well, when you spend $1 billion and buy more planes for Eastern Airlines, Mr. Borman, do you create more jobs, yourself, in your own company, or do you just replace those 10 planes with 10 other planes and therefore have the same ground crew, the same pilots, the same stewardesses, the same ticket purchasing agents, et cetera? Is that not just substitution? That does not create jobs, does it?

Mr. BORMAN. No, we have growth. I do not believe you could survive without growth in an industry as capital-intensive when you are in such an inflationary period.

Mr. GUARINI. Yes, but you do not have growth in your airline today. There are fewer people flying than ever, and still we want to have Eastern survive somehow or other. Could a Reconstruction Finance Company do more in giving you long term, low interest rates and arranging payments and subsidies that could more directly help your company in its expansion?

Mr. BORMAN. I would prefer that we not get to that point, and I think safe harbor leasing will avoid it.

Mr. GUARINI. Why? Why would you rather go through a surrogate and let the oil companies that are the biggest beneficiaries of this, get off the hook on paying taxes? There was a report that over 20 percent of the benefit has gone to oil companies, a report which just appeared in the paper yesterday. Why would we create this big bonanza for the oil companies when we are in effect really taking tax collectibles away from the American people?

Mr. BORMAN. Well, as we mentioned earlier, we think you can put limits on the buyers if that need be. On the other hand, my own concept of having been in a regulated industry and their having fought dramatically to avoid deregulation and then having been presented with it by the Congress and the President, even though it is more difficult, I am convinced in the long run our country is going to be better served. And the concept of an artificially subsidized Federal loan program does not appeal to me.

Mr. GUARINI. I would like to ask the other members of the panel. They all seem old enough to remember the Reconstruction Finance Corporation and how well it served our country, and I would just like to quickly ask——

Mr. TIPPETT. I would like to exclude myself from that group. [Laughter.]

Mr. GUARINI. We have a rejoinder.

But quickly, do you think that would be a good way of going?

Mr. SEIDMAN. I am old enough to remember that, and I think we were lucky to get out of that kind of a problem where the Government was deciding what investments ought to be made. You are not helping distressed industries except to buy new equipment. They are putting in most of the money. The Government is putting in a small part. And you are getting individual corporations with their own money making investments, and you are helping.

That is a totally different kind of structure than having Mr. Relix Rohatyn or any other of those very wise gentlemen decide whether or not this equipment ought to be bought. So I would think that it would be very inefficient to go back to that type of——

Mr. GUARINI. Well, the Banking Committee will be having hearings on this and I was just wondering whether there is any contrary opinion.

[No response.]

Chairman ROSTENKOWSKI. Mr. Rousselot will inquire.

Mr. ROUSSELOT. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Would the gentleman yield to me?

Mr. ROUSSELOT. Well, of course.

Chairman ROSTENKOWSKI. The Chair would like to announce that we expect to hear the second panel immediately after the first panel concludes. So, we will work through lunch.

Mr. Rousselot will inquire.

Mr. ROUSSELOT. Thank you, Mr. Chairman.

We appreciate your testimony and many of us want you to know—I cannot speak for everybody on the committee—that we do not expect, if there is some kind of change in this particular aspect of the tax bill, to make it retroactive. I think it should be understood that many of us realize that that would be—well, I will say

it—an ill-advised thing to do; but I am speaking only for myself on that.

Mr. Borman, I was interested very much in your closing statement that if there is a need to modify this legislation to prevent abuse, then changes should be made but repeal would have a drastic consequence for capital-intensive industries. Since you believe that it should not be repealed but that there may be a possible way that we could construct an amendment to modify or to try to prevent abuse, how would you put a cap on this program? Would you do it with a dollar amount or a percentage put on purchasers' tax liability? What would you do?

Mr. BORMAN. Yes, sir. I believe that, as has been suggested by the other panel members, a percentage of the tax liability would be the best way.

Mr. ROUSSELOT. Percentage of the tax liability.

Mr. BORMAN. It could be offset.

Mr. ROUSSELOT. What kind of a percentage?

Mr. BORMAN. We talked about 40 or 50 percent.

Mr. ROUSSELOT. About 40 or 50 percent.

Mr. BORMAN. My own feeling would be a cap that would not impede the marketplace. In other words, I do not want to be trying to sell benefits in a market that is constrained by a lack of buyers. The Arthur Andersen study showed 40 percent, so 40 percent would seem to me to be a good number.

Mr. ROUSSELOT. Does anybody else want to comment on what your judgment is, or does everybody concur?

Mr. TIPPETT. Yes, sir. It is our judgment that a 40 to 50 percent cap would not impede the market, that in fact there would be still a significant number of buyers, and we could operate in that environment.

Mr. ROUSSELOT. I wonder, Mr. Penick, I have heard your comment on part of this question, but have you done any study to determine, or could you do any study to determine what the reflow on taxes might be as a result of this law?

Mr. PENICK. I am not sure I understand what you mean by reflow.

Mr. ROUSSELOT. For example, in 1978 when we were considering legislation to reduce the capital gains tax, the Treasury at that time told us we were going to lose all this revenue. Of course, the opposite turned out to be the case. There was a tremendous reflow because, as you well know, people were more willing to take the capital gains and reinvest.

Could you guess what the reflow would be? Would you be willing to respond as to an estimate, since you have done a study on this, as to what the reflow might be as a result of this?

Mr. PENICK. You mean if it were repealed?

Mr. ROUSSELOT. No, if it remains in place as is.

Mr. PENICK. I think I see what you mean.

Mr. ROUSSELOT. I am not stating it very well. I am not a lawyer so I do not know how to state it.

Mr. PENICK. The Treasury survey which was released last week did indicate that somewhere between $19 and $20 billion of investment was made in 1981 that was subject to safe harbor leasing. Now, no one is suggesting that safe harbor leasing really stimulat-

ed all of that investment, but clearly, the suppliers of that equipment and the employees who had jobs to make the equipment that was subject to safe harbor leasing, that in turn is a significant element. Is that what you mean by reflow?

Mr. ROUSSELOT. Right.

Mr. PENICK. I have heard numbers that are perhaps 26,000 labor hours, man-hours, for the average $1 million investment.

Mr. ROUSSELOT. If you could without too much cost to yourself, since you have done this rather intensive study, give us some estimate back as to what the taxes paid would be on that reinvestment.

Mr. PENICK. I am not optimistic that our survey would give us that data, but we will think about it and see.

Mr. ROUSSELOT. I would appreciate it.

Mr. Chairman, since we have to go vote, I will submit any additional questions I have.

Chairman ROSTENKOWSKI. Mr. Vander Jagt is recognized.

Mr. VANDER JAGT. Thank you very much, Mr. Chairman. I appreciate the opportunity to thank the members of the panel. I apologize that I was not here to hear your statements. I have had a chance to look them over and I found that they were excellent and brought light to a controversial subject and a subject that needs some of the perpective you have brought this morning.

Now, so that the chairman and I will not miss the vote, I will yield back the balance of my time.

Chairman ROSTENKOWSKI. I take this opportunity to thank all of you for participating in this panel. Mr. Borman, I want to point something out. You made an investment based on the tax law as enacted. The investment was approximately $1 billion?

Mr. BORMAN. Yes, sir.

Chairman ROSTENKOWSKI. Well, the one thing about the Congress is that there is nothing certain. We passed a law last year that addressed the way Congressmen file their income taxes. The Senate is presently changing that law. So, we are all in the same boat. Thank you very much for joining us.

Mr. Russo will call the next panel.

Mr. RUSSO [presiding]. The next panel will be Paul Barrese from the American Mining Congress, John Kelley of the American Iron Ore Association, Howard Frey of the National Coal Association, and Robert Peabody from the American Iron & Steel Institute.

Mr. Barrese, proceed as you see fit. Your entire statement will be made a part of the record and you may summarize it.

STATEMENT OF PAUL A. BARRESE, DIRECTOR OF TAXES, ASARCO, INC., ON BEHALF OF THE AMERICAN MINING CONGRESS

Mr. BARRESE. Thank you, Mr. Chairman. I want to thank you for giving us the opportunity to come here today. My name is Paul A. Barrese, I am director of taxes at ASARCO, Inc. In addition to my oral remarks, we have submitted a written statement to the committee.

I am appearing before you today on behalf of the American Mining Congress. The American Mining Congress takes the follow-

ing positions regarding the administration's tax proposals: (a) Supports retention of safe harbor leasing; (b) opposes the new proposed corporate alternative minimum tax; and (c) opposes restrictions on industrial development bond financing.

The American Mining Congress strongly opposes the administration's proposals to repeal for all practical purposes a substantial part of the business tax reductions that were embodied in the Economic Recovery Tax Act of 1981.

In the aggregate, the fiscal 1983 budget indicates that the administration proposes to take from the corporate sector during the period of 1982 through 1985 approximately 50 percent of the corporate benefits enacted in the 1981 tax changes.

Mining is one of the most capital-intensive of all industries, and it is in dire need of funds to continue its long-term capital improvement plans. The leasing provisions and IDB financing have provided the needed incentive to carry on these plans.

In this regard, I would like to refer to a statement by the chairman of my company, ASARCO, in our latest annual report in his letter to stockholders:

> The financial position of the company was significantly enhanced by the Economic Recovery Tax Act of 1981. The results for 1981 included $34 million from tax benefit leasing arrangements. Without these provisions, it would have been more difficult for ASARCO to schedule our $140 million capital spending program for 1982. Thus, for companies like ASARCO, the tax benefit leasing provisions of the 1981 legislation proved to be a highly efficient means of supporting important capital expenditures by basic industry, a primary targeted objective of the administration's fiscal policy.

The corporate minimum tax proposal represents an about-face from the capital investment directed policy of last year. It creates an unstable investment climate and will deter needed capital formation and also the ability to create new and additional jobs. In many cases, the practical effect of the new minimum tax proposals is the repeal of a significant part of the investment tax credit. This will result from imposing the minimum tax, which is not reduced by investment credits, whenever it exceeds regular tax liability, after reduction for investment tax credits.

A minimum tax illogically falls on depressed profit industries or capital-intensive businesses generating large deductions or credits attributable to investments in new productive facilities. Imposition of the tax will hurt the capital formation efforts of capital-intensive industries experiencing depressed profits, including the mining and steel industries. Moreover, the proposal may also reduce incentives for domestic exploration and mine development and thereby exacerbate the Nation's dependence on foreign sources for strategic minerals.

IDB financing has made it possible for industry to improve air quality and lessened the cost associated with betterment of the environment, that is, pollution control, water treatment projects, et cetera. We do not view the use of tax exempt financing for these purposes as an abuse of this funding mechanism.

The American Mining Congress opposes the administration's proposed restrictions on industrial development bonds to the extent such financing for pollution control facilities would be significantly impaired. This form of financing is an essential aid in raising funds

for the enormous nonproductive investments required of the mining industry to comply with pollution control mandates.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF PAUL A. BARRESE, DIRECTOR OF TAXES, ASARCO, INC., ON BEHALF OF THE AMERICAN MINING CONGRESS

SUMMARY

The American Mining Congress strongly opposes the Administration's proposals to take back for all practical purposes a substantial part of the business tax reductions enacted in the Economic Recovery Tax Act of 1981. Of particular concern is the proposal for a corporate minimum tax.

The corporate minimum tax proposal represents an about face from the capital investment directed policy of last year, creates an unstable investment climate, and will deter needed capital formation.

In many cases, the practical effect of the new minimum tax proposals is the repeal of a significant part of the investment tax credit. This will result from imposing the minimum tax, which is not reduced by investment credits, whenever it exceeds regular tax liability after reduction for investment tax credits.

The impact on the mining industry of the corporate minimum tax proposal is particularly inequitable. The American Mining Congress supported the ACRS system and investment credit improvements enacted under the Economic Recovery Tax Act of 1981. The AMC believed that enactment of these provisions would stimulate needed investment and lead to improvement of productivity growth rates. The entire mining industry will benefit in the long-run from improved general economic conditions resulting from the cost recovery system, even though, except for the safe harbor leasing provisions, the mining industry will derive little immediate direct benefit from these changes.

A minimum tax illogically falls on depressed profit industries or capital intensive businesses generating large deductions or credits attributable to investments in new productive facilities. Imposition of the tax will hurt the capital formation efforts of capital intensive industries experiencing depressed profits, including the mining and steel industries. Moreover, the proposal may also reduce incentives for domestic exploration and mine development and thereby exacerbate the Nation's dependence on foreign sources for strategic minerals.

The American Mining Congress also strongly urges continuation of the safe harbor leasing provisions. Those provisions are necessary to extend investment incentives to depressed profit, capital intensive industries, provide neutrality of tax treatment for investments, provide funds for the expansion, modernization, and revitalization of productive facilities, and deter tax-motivated takeovers and mergers.

The American Mining Congress opposes the Administration's proposed restrictions on industrial development bonds to the extent such financing for pollution control facilities would be significantly impaired. This form of financing is an essential aid in raising funds for the enormous nonproductive investments required of the mining industry to comply with pollution control mandates.

STATEMENT

Mr. Chairman and members of the committee, my name is Paul A. Barrese. I am Director of Taxes at ASARCO Incorporated.

I am appearing before you today on behalf of the American Mining Congress. We appreciate this opportunity to testify with regard to the tax proposals made by the Administration in its budget recommendations for fiscal year 1983.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U.S. companies that produce most of the nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

The American Mining Congress strongly opposes the Administration's proposals to repeal for all practical purposes a substantial part of the business tax reductions that were embodied in the Economic Recovery Tax Act of 1981. In the aggregate, the fiscal 1983 budget indicates that the Administration proposes to take from the corporate sector during the period of 1982 through 1985 approximately 50 percent of the corporate benefits enacted in the 1981 tax changes.

In particular, the American Mining Congress is most concerned with the Administration's proposal for a corporate alternative minimum tax and its proposal with respect to tax exempt industrial development bonds.

CORPORATE MINIMUM TAX

The Administration's proposal for a corporate minimum tax, which would fall most heavily on those businesses making needed capital investments, is a complete about-face from its proposals of last year. By the corporate minimum tax proposal, the Administration will penalize capital investment and thus create an unfavorable climate for needed capital formation.

The proposal reverses the thrust of the Economic Recovery Tax Act and it cannot but hurt the prospects for recovery from the recession presently being experienced by this country.

It is important to note that stability of investment climate is an extremely important factor in allowing needed investment decisions and programs to be undertaken. The Administration, however, by its tax proposals has created a climate of instability. Last year it argued strenuously for enactment of tax provisions to stimulate capital investment—the ACRS system and investment tax credit improvements. This year it proposes to significantly take back those tax benefits and to penalize the making of capital investments. This flip-flop in tax policy is most disruptive to sound investment decisions.

The serious impact of the corporate minimum tax proposal on capital investment is illustrated by the fact that it will significantly increase the tax liability of a corporate taxpayer which has absolutely no "tax preferences" but which, because it is in a capital intensive industry and made needed capital investments, has substantial investment tax credits. In effect, under the Administration's proposal the present 90 percent of tax liability limitation on the use of investment credits would be reduced by more than a quarter to approximately 67 percent. In other words, the practical effect of the Administration's proposal is the deferral of the use of a substantial portion of investment tax credits. Where an industry is in a depressed profit position and the length of this deferral extends to a number of years, it then becomes equivalent to the repeal of a significant portion of the investment credit.

Not only is the Administration's corporate minimum tax proposal unwise generally from the standpoint of the need to stimulate capital investment, it is particularly inequitable in its impact on the mining industry. There is no question that mining is one of the most capital intensive of all industries. Indeed, in recent years the mining industry's capital needs have been significantly increased by reason of factors such as environmental, health and safety, and other government-mandated expenditures as well as the high costs of debt, rapidly escalating costs resulting from inflation, rising energy costs, and low profitability in the case of a number of our major mineral sectors. Although the mining industry did not anticipate that it would receive direct or immediate tax benefit from the ACRS and investment tax credit proposals of the Administration last year, because of the cyclical depressed profit situation of the industry, the mining industry nevertheless strongly supported the Administration's proposals. The mining industry believes those proposals—which were enacted as part of the 1981 Economic Recovery Tax Act—will stimulate investment and improve productivity growth rates and, thus, will improve economic conditions generally. That general improvement in economic conditions in the long run will benefit the mining industry.

For these reasons, the mining industry supported the business tax provisions proposed by the Administration in 1981 even though, except for the safe harbor leasing provisions, they were of little direct benefit to the industry. The Administration's present corporate minimum tax proposal, however, will have a major detrimental impact on the mining industry. A survey of a number of member companies of the American Mining Congress indicates that the Administration's proposed corporate minimum tax could increase their total federal tax liabilities by more than $100 million per year. The actual impact on the mining industry would be even greater than this since this estimate does not include the mining operations of iron and steel companies.

Thus, in the case of the mining industry, the Administration's corporate minimum tax proposal in many cases will negate the benefits derived from the Economic Recovery Tax Act of 1981 and in other cases will place companies in even a worse tax position than if the 1981 Act had never been enacted.

The Administration's proposal thus will not only adversely affect the ability of the mining industry to make needed capital investments but it also will adversely impact the exploration for and development of domestic sources for strategic miner-

als. The dependence on foreign sources for a number of strategic minerals is already a serious problem, as is illustrated by the Bureau of Mines charts which are included as Appendix A.

In addition to these economic and business investment considerations, it should be noted that the Administration's corporate minimum tax proposal also is unsound tax policy. It would impose a tax on the very businesses which make the investments and take the actions that the investment tax credit, the ACRS system and other specified tax provisions were enacted to encourage. Thus, those businesses which make investments in new plant and equipment could, solely by virtue of the tax benefits accorded those investments, become subject to the minimum tax. Moreover, the impact of the proposed corporate minimum tax is greatest when a business is in a depressed profit position—a most illogical result.

SAFE HARBOR LEASING

The American Mining Congress also is quite concerned with the suggestions that have been made to eliminate the safe harbor leasing provisions enacted last year. We strongly support the continuation of those provisions, although we recognize that changes may have to be made to deal with perceived abuses. The safe harbor leasing provisions are needed for the following reasons:

1. *Investment incentives.*—The leasing provisions are necessary to extend the ACRS and investment tax credit investment incentives to all businesses, regardless of their tax posture. This is particularly relevant for those major capital intensive industrial segments that are presently in a depressed profit position such as the automobile, steel, mining, airline, railroad, and paper products industries. Without safe harbor leasing, the intended incentives for investment in new productive facilities—the investment tax credits and the ACRS deductions—would not be available to these sectors.

2. *Tax neutrality.*—Tax policy should be neutral to the maximum extent possible as between companies making essentially identical capital expenditures. Safe harbor leasing provides the desired tax neutrality and, thus, allows the marketplace to allocate capital investment to the most efficient uses. Safe harbor leasing will not change a bad investment in new equipment into a good one. No lessor will provide funds for an investment that is not economically viable. In this regard, safe harbor leasing is essentially no different from traditional equipment leasing which has long been used as a financing tool. Thus, it is not proper to say that safe harbor leasing subsidizes inefficient "loser" companies.

3. *Funds for investment.*—The safe harbor leasing provisions provide safe harbor lessees—the users—with funds that enable them to make capital expenditures that otherwise would have been postponed or perhaps not made at all. Thus, these provisions allow the mining industry to make the capital investments needed to expand, modernize, and revitalize as intended by the 1981 Act.

4. *Most benefits are passed through to the lessee-users of equipment.*—The effect of the safe harbor leasing provisions is to provide lessee-users with total benefits (the initial cash payment plus the tax benefit of rental deductions) that approximate the tax benefits associated with ownership of the property. Moreover, as the marketplace has become more experienced with the safe harbor leasing provisions, the trend has been to higher initial cash payments and thus greater benefits to the lessee-user-investor in new productive facilities.

5. *Leasing deters tax-motivated takeovers and mergers.*—In the absence of safe harbor leasing that permits them to utilize cost recovery deductions and investment tax credits, many depressed profit companies would accumulate net operating loss carryovers and investment tax credit carryovers, thereby making them more attractive takeover targets. The economic concentration resulting from such takeovers could have an adverse impact on competition.

The American Mining Congress recognizes that Congress may wish to review the law to see if unintended benefits have been derived from the provisions. Indeed, it might be appropriate to impose a cap or overall limit on the amount to which a lessor may reduce tax liabilities. Of course, a cap or tax liability limit such as this could be done directly without resorting to an alternative minimum tax machine under which a lessor's safe harbor leasing benefits are taxed as an item of tax preference.

IDB FINANCING OF POLLUTION CONTROL FACILITIES

The mining industry has been faced with increasingly heavy capital expenditures to meet the many new environmental requirements imposed on it. Moreover, in future years the mining industry will be required to spend large amounts of capital

for pollution control facilities and other government-mandated expenditures. Industrial revenue bond finance for pollution control facilities provides some easing of the financial burden on the industry of meeting pollution control standards.

Accordingly, the American Mining Congress opposes the restrictions proposed by the Administration to the extent industrial development bond financing for pollution control facilities would be significantly impaired.

APPENDIX A

U.S.S.R. NET IMPORT RELIANCE OF SELECTED MINERALS AND METALS AS A PERCENT OF CONSUMPTION IN 1980

1/ SOURCES SHOWN ARE POINTS OF SHIPMENT TO THE U.S.S.R. AND ARE NOT NECESSARILY THE INITIAL SOURCES OF THE MATERIAL.

*NET IMPORTS = IMPORTS - EXPORTS
**APPARENT CONSUMPTION = DOMESTIC MINE OUTPUT + NET IMPORTS

FEBRUARY 1982

BUREAU OF MINES, U.S. DEPARTMENT OF THE INTERIOR

U.S. NET IMPORT RELIANCE OF SELECTED MINERALS AND METALS AS A PERCENT OF CONSUMPTION IN 1981 [1]

MINERALS AND METALS [2]
NET IMPORT RELIANCE* AS A PERCENT OF APPARENT CONSUMPTION**
0% 25% 50% 75% 100%
MAJOR FOREIGN SOURCES [3] (1977-1980)
COLUMBIUM 100 BRAZIL, CANADA, THAILAND
DIAMOND (industrial stones) 100 IRELAND, REP. OF SOUTH AFRICA, BELG.-LUX., U.K.
GRAPHITE (natural) 100 MEXICO, REP. OF KOREA, MADAGASCAR, U.S.S.R.
MICA (sheet) 100 INDIA, BRAZIL, MADAGASCAR
STRONTIUM 100 MEXICO
MANGANESE 99 REP. OF SOUTH AFRICA, GABON, FRANCE, BRAZIL
BAUXITE & ALUMINA 94 JAMAICA, AUSTRALIA, GUINEA, SURINAME
COBALT 91 ZAIRE, BELG.-LUX., ZAMBIA, FINLAND
TANTALUM 91 THAILAND, CANADA, MALAYSIA, BRAZIL
CHROMIUM 90 REP. OF SOUTH AFRICA, PHILIPPINES, U.S.S.R., FINLAND
FLUORSPAR 85 MEXICO, REP. OF SOUTH AFRICA, SPAIN, ITALY
PLATINUM—GROUP METALS 85 REP. OF SOUTH AFRICA, U.S.S.R., U.K.
ASBESTOS 80 CANADA, REP. OF SOUTH AFRICA
TIN 80 MALAYSIA, THAILAND, BOLIVIA, INDONESIA
NICKEL 72 CANADA, NORWAY, BOTSWANA, AUSTRALIA
POTASH 68 CANADA, ISRAEL
ZINC 67 CANADA, MEXICO, SPAIN, AUSTRALIA
CADMIUM 63 CANADA, AUSTRALIA, MEXICO, BELG.-LUX.
TUNGSTEN 52 CANADA, BOLIVIA, MAINLAND CHINA, THAILAND
ANTIMONY 51 REP. OF SOUTH AFRICA, BOLIVIA, MAINLAND CHINA, MEXICO
SILVER 50 CANADA, MEXICO, PERU, U.K.
SELENIUM 49 CANADA, JAPAN, YUGOSLAVIA
BARIUM 43 PERU, MAINLAND CHINA, IRELAND, MOROCCO, CHILE
TITANIUM (ilmenite) 43 AUSTRALIA, CANADA, REP. OF SOUTH AFRICA
VANADIUM 42 REP. OF SOUTH AFRICA, CHILE, CANADA
MERCURY 39 SPAIN, ALGERIA, JAPAN, ITALY
GYPSUM 37 CANADA, MEXICO, JAMAICA
IRON ORE 28 CANADA, VENEZUELA, BRAZIL, LIBERIA
IRON & STEEL 14 JAPAN, EUROPE, CANADA
LEAD 10 CANADA, MEXICO, PERU
GOLD 7 CANADA, U.S.S.R., SWITZERLAND
SULFUR 7 CANADA, MEXICO
COPPER 5 CHILE, CANADA, PERU, ZAMBIA
0% 25% 50% 75% 100%

*NET IMPORT RELIANCE = IMPORTS-EXPORTS +ADJUSTMENTS FOR GOV'T AND INDUSTRY STOCK CHANGES

**APPARENT CONSUMPTION = U.S. PRIMARY +SECONDARY PRODUCTION + NET IMPORT RELIANCE

1/ JANUARY 20, 1982 (ESTIMATE).

2/ SUBSTANTIAL QUANTITIES ARE IMPORTED FOR RUTILE, RHENIUM AND ZIRCON. DATA WITHHELD TO AVOID DISCLOSING COMPANY PROPRIETARY DATA.

3/ SOURCES SHOWN ARE POINTS OF SHIPMENT TO THE U.S. AND ARE NOT NECESSARILY THE INITIAL SOURCES OF THE MATERIAL.

BUREAU OF MINES, U.S. DEPARTMENT OF THE INTERIOR
(import-export data from Bureau of the Census)

Mr. RUSSO. Thank you very much, Mr. Barrese.
John Kelley?

STATEMENT OF JOHN L. KELLEY, CHAIRMAN, TAX COMMITTEE, AMERICAN IRON ORE ASSOCIATION

Mr. KELLEY. Mr. Chairman and other distinguished members of the committee, my name is John L. Kelley. I am chairman of the tax committee of the American Iron Ore Association, and vice president for tax of the Cleveland Cliffs Iron Co. It is on behalf of American Iron Ore Association that I am appearing before you today.

Our association which has its headquarters in Cleveland, Ohio, is a trade organization representing companies that mine approximately 75 percent of the iron ore produced in the United States and Canada, as well as a substantial amount of iron ore produced in the free world. We remain in full support of President Reagan's 1981 economic program, which is directed toward a reduction of Government excesses and an increase in savings, investment and productivity in the private sector. We are convinced it is sound and will work.

Consequently, those portions of the Economic Recovery Tax Act of 1981 which were designed to stimulate savings and capital formation should not be altered in any substantial way. We also applaud the Congress for its bipartisan cooperation in bringing about the 1981 Tax Act, and we ask that overall policy reversals not be entertained at this time.

Although we share the concern for continuing long-term Federal deficits, we believe that hastily developed tax legislation is likely to be counterproductive and to have a long-term damaging effect. In addition to requesting further that an all-out effort be applied to bring about spending reductions by the Federal Government, we offer the following comments with regard to the administration's 1982 tax proposals.

First, we support the proposition that all entities with incomes should pay tax, but we cannot support the administration's minimum tax proposal because it reaches beyond income and disregards several important features of established tax law such as the application of investment tax credits and of net operating losses from other years, and because it makes a very grave error in designating mine exploration and development as a so-called preference item.

Second, Congress has selected safe harbor leasing as a means of channeling cash in the direction of capital investment needs, working in tandem with other capital investment incentives. Its use has probably already crested; however, if modification of this feature of the tax law is necessary, it should be accomplished directly after appropriate study and not by a quick-fix approach.

Third, with economic conditions in basic industries worsening daily and with an increased need to dispense with the add-on corporate minimum tax, we cannot understand the administration's reasoning. Being proposed is a more burdensome and ill-conceived minimum tax on selected deductions of capital-intensive taxpayers who suddenly happen to possess unlucky facts under a new and different standard.

The importance of stability in the income tax system to long-term investment decisions should not be underestimated. So if tax revenues do become necessary soon, we ask that permanent tax legislation be appropriately directed toward valid problem areas, and that any interim measures be chosen very carefully and be temporary in nature.

In recognition of your request, Mr. Chairman, that witnesses suggest to this committee alternative revenue proposals, we respectfully recommend that due consideration be given only if additional revenues from business are absolutely necessary to all of the following interim and temporary measures which are not listed in any particular order. In each alternative, as with the administration's proposals, the add-on corporate minimum tax should permanently be repealed.

Alternative 1. Adopt a temporary income tax surcharge.

Alternative 2. Impose temporary excise taxes on appropriate items to be very carefully selected by Congress.

Alternative 3. After completion of appropriate investigation by Congress, consider placing a reasonable temporary limit upon the annual reduction of regular taxable income, and or tax liability that can occur with respect to any particular lessor corporation as the result of safe harbor leasing transactions. Owner/users would remain unaffected.

Alternative 4. Adopt a broad-based, temporary alternative minimum tax on a sound financial base at an appropriate rate, perhaps phasing out to zero over 2 years, which gives proper recognition to investment tax credits, net operating losses and foreign taxable income distinctions and all other elements comprising its base.

In conclusion, we ask that you move with care and deliberation in matters of major tax policy; that spending cuts be pursued with determination and that justified tax revenue increases be appropriately directed toward valid problem areas or be temporary in nature.

Finally, the administration's minimum tax proposal should be defeated and the existing add-on corporate minimum tax should be repealed. Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN L. KELLEY, CHAIRMAN, TAX COMMITTEE, AMERICAN IRON ORE ASSOCIATION

SUMMARY

The American Iron Ore Association remains in full support of President Reagan's 1981 economic program which is directed toward a reduction of government excesses and an increase in savings, investment and productivity in the private sector. We are convinced that the program will bring positive results to our entire economy and to all citizens. Consequently, those provisions contained in the Economic Recovery Tax Act of 1981, which are directly related to the basic objective to stimulate savings and capital formation, should not be altered in any substantial way.

We also applaud the Congress for its bi-partisan cooperation in bringing about the 1981 Tax Act, and we ask that any inclination that may exist in Congress toward an overall policy reversal at this time be rejected.

Although we fully recognize and share the concern for continuing long-term federal deficits, we believe that hastily developed tax legislation is likely to be counterproductive and to have a long-term damaging effect. In addition to requesting further that all-out effort be applied to bring about spending reductions by the federal

government, we offer the following specific comments with regard to the Administration's 1982 tax proposals:

(1) Although we support the proposition that all entities with income should pay tax, we cannot support the Administration's minimum tax proposal because it reaches beyond income and disregards several important features of established tax law. We are most concerned about the Administration's failure to permit the application of investment tax credits and of net operating losses from other years and about its very grave error of designating mining exploration and development as a so-called "preference" item.

(2) Congress has selected "safe harbor leasing" as a means of channeling cash in the direction of capital investment needs. This initiative was designed to work in tandem with other capital investment incentives. Its use has in all probability already crested due to the relief from pressure accumulated in past years; but in any event, if modification of this or any other feature of tax law is now, or in the future becomes, necessary, it should be accomplished directly following appropriate study and not by a "quick fix" approach, such as the Administration's ill-conceived minimum tax proposal which would place a levy on various other selected tax deductions of taxpayers who suddenly happen to possess unlucky facts under a new and different standard.

(3) Regarding the expressed reasoning offered in support of certain other miscellaneous proposals by the Administration to increase business taxes in 1982, we question whether the case has been made.

(4) With economic conditions in basic industries worsening daily and with an increased need to dispense with the add-on corporate minimum tax, we are at a loss to understand the reasoning of the Administration in suggesting a new alternative minimum tax which would be even more burdensome to our member companies.

The importance of stability in the income tax system to long-term investment decisions cannot be underestimated. Thus, we question whether the need for increased income taxes at this time has been established, considering the very short period of time since the 1981 Act was passed. If it is subsequently determined that there is a substantiated need for additional income tax revenues, we ask that permanent tax legislation be appropriately directed toward valid problem areas and that any interim measures be chosen very carefully and be temporary in nature.

American Iron Ore Association respectfully recommends that due consideration be given to the following interim and temporary measures. In each alternative, as with the Administration's proposals, the add-on corporate minimum tax would be permanently repealed.

(1) Adopt a temporary income tax surcharge.

(2) Impose temporary excise taxes on appropriate items to be very carefully selected by Congress.

(3) After completion of appropriate investigation by Congress, consider placing a reasonable, temporary limit upon the annual reduction of regular taxable income and/or tax liability that can occur with respect to any particular lessor corporation as the result of safe harbor leasing transactions. Owner/users would remain unaffected.

(4) Adopt a broad-based temporary alternative minimum tax on a sound financial base at an appropriate rate (perhaps phasing out to zero over two years) which gives proper recognition to investment tax credits, net operating losses, and foreign taxable income distinctions and all other elements comprising its base.

In conclusion, we strongly urge that the substance of the Economic Recovery Tax Act of 1981 remain intact; that policy reversals in tax policy not occur; that all-out effort be applied to reduce federal government spending; that the Administration's minimum tax proposal be defeated; that the existing corporate add-on minimum tax be repealed; that adequate study precede the enactment of all major tax legislation; and that serious consideration be given to our alternative suggestions for temporary revenue increases.

STATEMENT

Mr. Chairman and other distinguished members of the Committee. My name is John L. Kelley. I am Chairman of the Tax Committee of American Iron Ore Association and Vice President-Tax, The Cleveland-Cliffs Iron Company. It is on behalf of American Iron Ore Association that I am appearing before you today. Our Association which has its headquarters in Cleveland, Ohio, is a trade organization representing companies that mine approximately 75 percent of the iron ore produced in the United States and Canada, as well as a substantial amount of iron ore produced in the free world.

The Reagan Administration is presently under severe attack by some critics, both in and out of government, who would enjoy nothing more than to see its economic policies fail. The American Iron Ore Association is not to be identified with this segment of the population. We firmly agree with the Administration's assessment that government spending has gotten out of hand and that many involvements and "entitlements" of government have grown much too large.

Inflation has been labeled the cruelest tax of all, but it doesn't get attention through negative publicity because of its impersonal nature. President Reagan's economic program of 1981 is aimed at government excesses and inflation. We remain convinced that the program will bring positive results to our entire economy and to all citizens, but a redirection of government this vast cannot possibly be evaluated as to its effectiveness within six months after being put in place. We ask that you not permit the present dialogue and confusion over federal deficits to lead to tampering with the substance of the 1981 economic program, of which business taxation is only one element.

The American Iron Ore Association is not unmindful of our country's present fiscal situation, and it sincerely appreciates the anxiety of those who believe the anticipated deficit for the upcoming fiscal year will be excessive or will lead to even greater continued deficits in subsequent years. On the other hand, we strongly oppose this hastily developed new approach by the Administration to impose substantially higher taxes on capital intensive business, and we question the justification for legislation to increase income taxes by any means at this particular time. However, if it is subsequently determined that there is a substantiated need for additional income tax revenues, we ask that permanent legislation be directed toward identified and valid problem areas and that any interim solution be chosen very carefully and be temporary in nature.

During 1981, when the Administration's economic program was being debated, iron ore and steel companies were in a definite economic slump. As we've moved into 1982, economic conditions have worsened; and our industry is now suffering from the largest and most extended cutback in demand for its products in the last quarter century. But, we do not attribute our present economic tribulations to the recently enacted and instituted programs of the Administration. It is clear to us that this country and our industry now have an international problem of immense proportions. In this regard on an even broader scale we also believe that a nation which seems to have an insatiable demand for, and an ability to consume, leisure-time activities, while its basic industries and natural resource capabilities are faltering, should be raising some fundamental questions about its overall sense of direction.

LAST YEAR'S SUPPORT OF THE ADMINISTRATION'S ECONOMIC PROGRAM

In 1981 the American Iron Ore Association submitted written statements to your committee and to the Committee on Finance in connection with the President's economic program and tax reduction proposals. Our organization strongly supported the Administration's 1981 economic package which called for a significant reduction in federal spending, coupled with a reduction of individual income marginal tax rates across-the-board over a three-year period and the establishment of the Accelerated Cost Recovery System. We commend the Administration and the Congress for their determination in establishing these initiatives through bi-partisan legislative effort; and now that implementation has begun we remain of the firm view that these actions, if left in place and substantially intact, will prove to be of vital assistance in helping to satisfy our nation's desperate need for improved productivity and increased rates of savings and investment.

Our statements for the hearings record in 1981 also supported the Administration's original request for a "clean" tax bill to be followed by a second bill of broader latitude, and we expected that any such considerations of consequence would be the object of a further hearings process. As it turned out, the single major piece of tax legislation that sprung forth in 1981 in the form of the Economic Recovery Tax Act contained a variety of significant and far-reaching provisions that were not directly the subject of the public hearing process. Before speaking directly to this year's considerations, we wish to say that the hearings procedure of 1981 should not serve as the model for consideration and enactment of important new tax legislation in the future.

AN UNCERTAIN TAX ATMOSPHERE IS TO BE AVOIDED

Throughout the past decade, there has been an increasing trend toward instability in our federal tax system. This ever-present lack of certainty has serious nega-

tive implications on any sound business decision-making process. Now, with the Administration proposing significant new tax legislative proposals just six months following the enactment of the Economic Recovery Tax Act of 1981, we seem to have reached an all-time high for instability in the tax legislative process. We view the present situation of having to deal with a policy reversal proposal in early 1982 with deep reservations and skepticism.

THE PROPOSED MINIMUM TAX ON SELECTED BUSINESS DEDUCTIONS HAS MANY SERIOUS SHORTCOMINGS

Many of the member companies of the American Iron Ore Association have been adversely affected by the present add-on minimum tax for corporations. In testimony of several prior years, this organization, in calling for repeal of the minimum tax, has pointed out the onerous impact this tax has on corporate enterprises carrying on iron ore mining operations in terms of its drain on capital formation and needed cash flow. With present economic conditions in our industry worsening daily and an increased need to dispense with the ill-conceived tax on tax deductions, we are at a loss to understand the reasoning of the Administration in suggesting a new alternative minimum tax which would be even more burdensome to our member companies. Although we do applaud the Administration for suggesting a repeal of the add-on minimum tax, we certainly cannot subscribe to a more onerous minimum tax in its place. (We are not submitting quantitative data as to the adverse consequences of the Administration's proposal on our membership because, for the most part, it would constitute duplication of amounts included in the several hundred million dollar total which is being communicated in testimony by other organizations representing the mining and steel industries.)

The construction of the Administration's alternative minimum tax proposal is of the "quick fix" variety, overriding and substantially diminishing by an indirect formula approach a wide variety of selected provisions of the existing Internal Revenue Code (i.e., net operating losses, investment credits, foreign tax credits, and the chosen "bad" deductions such as mine development). Furthermore, we see in the Administration's proposal an attempt to sanctify an aberration of corporate business taxation. No substantiation has ever been advanced to support the taxation of corporate tax deductions. The add-on minimum tax came into law in 1969 without benefit of a full hearing process as a by-product of the drive to insure payment of some tax by a few high income individuals who reportedly had been successfully sheltering substantial amounts of income from tax. Likewise, there has never been substantiation advanced to support the arbitrary 15% rate which was established in 1976 as an increase from 10%, which also never had been the subject of rational explanation.

The American Iron Ore Association supports the proposition that all entities with economic income should pay some tax, but it virgorously challenges any implication that our opposition to the Administration's alternative minimum tax proposal (or to the existing add-on minimum tax statute for the matter) constitutes a rejection of that proposition. In reality, the Administration's proposal reaches far beyond the taxation of economic income, and it is this overextension that causes us difficulty. It certainly is obvious that the Administration did not attempt to define economic income, and it appears as though there was no independent consideration given to the proper rate of taxation to be applied thereto in the few short weeks from the President's announcement of the intended "strengthening" of the minimum tax in his State of the Union message in January to the Treasury Department release in February.

In addition to the promotion of an ill-founded concept for taxation, the Administration's proposal creates an unnatural and undesirable setting for controversy. This is an extremely serious problem in our estimation. Rather than focusing upon the aspects of existing tax law which are deemed worthy of review, your committee's attention is being focused on so-called "preferences" and a new form of tax complexity which will extract under a new scheme substantial revenues from many corporations with unlucky facts under a new and different set of standards. If various business interests are enticed into defending particular "preferences" being suggested for taxation, should it be implied that the concept itself and the rate are acceptable? If no such defense is advanced, does this establish the worthiness of any particular item as a "preference"? We believe the answer to both questions is emphatically no, but we still feel obliged to point out that the Administration's proposed treatment of net operating losses and investment credits and the identification of mine exploration and development as a "preference" are completely indefensible and grossly inequitable. These three aspects and the inherent permanence of

the concept would cause us the greatest resistance to the tax, even if the need for tax revenues at this time could be justified. Moreover, the stacking of "tax preference" items upon the income of foreign branches discriminates in favor of those who conduct their business through foreign subsidiaries. We believe that discrimination in this manner encourages the incorporation of foreign branches into foreign subsidiaries and, therefore, is not sound tax policy.

In summary, we are troubled to find that the present Administration has come under such extreme criticism and premature pressure with regard to recently enacted capital formation incentives that it has abruptly and prematurely seized upon this ill-founded minimum tax proposal. Considering the relatively minor impact on Treasury revenues, coupled with the dramatic, misdirected and inequitable increase in tax cost to certain capital intensive mining corporations, it is not possible for us to understand the rationale. What seems to have been forgotten is that this country's basic industries have been engaged in an economic war with their foreign competitors and that the Economic Recovery Tax Act of 1981 has provided assistance in overcoming a serious international disadvantage. The Administration's 1982 proposal would again deprive many capital intensive industries of this long-awaited economic stimulus. If the private enterprise system is to survive and prosper in the face of competition from nationalized and foreign government supported competition, this country must continue to provide the mining and basic industrial segments of our economy with necessary tools through an economically viable income tax system.

CASH FLOW FROM CAPITAL COST DEDUCTIONS AND INVESTMENT CREDIT UTILIZATION IS VITAL

In 1981, the statement submitted to your committee by this organization pointed out that substantial expenditures by our member companies, which were undertaken in recent prior years for plant expansions, modernizations, and governmentally mandated expenditures, had given rise to an accumulation of unused investment credits. At that time we observed that depressed earnings were also restricting the utilization of these available credits, and we called for a program in which credit utilization might be enhanced, at least for the short term.

As is generally known, "safe harbor leasing" was ultimately enacted in 1981 as a means by which newly created credits and capital cost deductions can give rise to immediate cash flow in the current year, thus avoiding further build-up of unused balances. Now that Congress has selected this vehicle to help generate cash where capital investment is taking place, we recommend that its basic elements remain intact long enough to permit adequate evaluation of its effectiveness. We have no reason as yet to think that this general type of legislation is not already serving the intended purpose of stimulating the movement of funds toward investment in needed production facilities, and we strongly advise against impulsive and exaggerated negative reactions in this area of tax legislation. It should also be observed that in future years under existing tax law it is extremely unlikely that there could occur a repeat condition of 1981, whereby such large amounts of unused credits that had accumulated over so many years were backed up and unutilized.

Also, without question, self-use of tax credits and deductions will always be economically preferable whenever income is adequate, so it is predictable and understandable that the tide of "safe harbor leasing" will never again rise to the level already reached since passage of the 1981 Act. If it ever does, it will most likely constitute an indication of very severe economic hardships throughout the economy with implications extending far beyond the tax code. Certainly, there must be initial close scrutiny of this and any other tax legislation of such magnitude and importance, and it is quite likely that modifications and/or fine tuning may be necessary now to curb abuses and to insure that the intended purpose is being fulfilled in all cases; but it seems much too early for there to develop a wholesale loss of faith in its usefulness.

OTHER PROPOSALS BY THE ADMINISTRATION

The American Iron Ore Association is not as perplexed about the remaining tax revision proposals announced by the Treasury on February 26, although we do question some of the expressed reasoning with regard to certain items; but we must reiterate our conviction that, overall, this hasty initiative to raise business taxes in 1982 legislation on a broad scale (primarily from capital intensive industries) is both unwarranted and unsettling to us, especially so soon following the 1981 enactment.

ALTERNATIVE REVENUE PROPOSALS

In recognition of your request, Mr. Chairman, that witnesses suggest to this Committee alternative revenue proposals, American Iron Ore Association respectfully recommends that due consideration be given to the following interim and temporary measures. In each alternative, as with the Administration's proposals, the add-on corporate tax would be permanently repealed.

(1) Adopt a temporary income tax surcharge.

(2) Impose temporary excise taxes on appropriate items to be very carefully selected by Congress.

(3) After completion of appropriate investigation by Congress, consider placing a reasonable, temporary limit upon the annual reduction of regular taxable income and/or tax liability that can occur with respect to any particular lessor corporation as the result of safe harbor leasing transactions. Owner/users would remain unaffected.

(4) Adopt a broad-based, temporary alternative minimum tax on a sound financial base at an appropriate rate (perhaps phasing out to zero over two years) which gives proper recognition to investment tax credits, net operating losses, and foreign taxable income distinctions and all other elements comprising its base.

In conclusion, we strongly urge that the substance of the Economic Recovery Tax Act of 1981 remain intact; that policy reversals in the policy not occur; that the Administration's minimum tax proposal be defeated; that the existing corporate add-on minimum tax be repealed; that adequate study precede the enactment of all major tax legislation; and that serious consideration be given to our alternative suggestions for temporary revenue increases.

Mr. RUSSO. Thank you very much, Mr. Kelley. The next witness will be Howard Frey. Mr. Frey, your entire statement will be made a part of the record; therefore, it would be appreciated if you would summarize it.

STATEMENT OF HOWARD H. FREY, VICE CHAIRMAN AND CHIEF ADMINISTRATIVE OFFICER, WESTMORELAND COAL CO., ON BEHALF OF THE NATIONAL COAL ASSOCIATION

Mr. FREY. Mr. Chairman, I am Howard Frey, vice chairman and chief administrative officer of Westmoreland Coal Co., Philadelphia, Pa. I am testifying on behalf of the National Coal Association. My detailed statement has been submitted for the record.

To produce enough coal to fuel economic recovery and future growth will require at least $50 billion over the next 8 years for new investments in mines and other facilities—roughly 3½ times our present capitalization. But the fact is, Mr. Chairman, that the coal industry is facing large increases in production costs and declining profit margins at the very time when we must plan for industry expansion. The highest degree of investment incentive is a necessity.

For these reasons, we urge the repeal of the present corporate minimum tax and the committee's rejection of the alternative minimum tax which is being proposed. Both taxes, we believe, are contrary to the goals of sound economic growth. They also work a special hardship on low profit, capital-intensive industries such as coal. The minimum-tax concept would dilute the tax incentives intended to help spur new investment which are key to the Economic Recovery Tax Act of 1981.

Coal mining is granted a 10-percent depletion allowance, but few coal producers can take full advantage of the incentives offered because of the 50 percent of net income limitation. Our studies show that from 1975 to 1980, the coal industry's effective depletion rate

dropped from just over 7 percent to just under 5 percent, illustrating the industry's declining profit margins.

By adding mining exploration and development costs as a preference item, many coal companies and other mining interests will be further starved for investment capital. As a case in point, for the years 1976 through 1981, Westmoreland and its operating subsidiaries incurred exploration and development costs amounting to over $47 million. Had these costs been subject to the minimum tax, the company would have been required to pay out an additional $7 million in Federal income tax.

The coal industry also supports preserving the so-called safe harbor leasing provision. It will stimulate investment in new mines and other facilities. I understand the logic behind the proposals to repeal this provision, that leasing is a subsidy for the inefficient, but we do not agree with this assumption.

I wanted to point out that some companies are paying low tax rates not because they have low taxable income, but because they have low profit margins which is wholly consistent with responsible tax policy. Westmoreland, for example, had, as of December 31, 1981, approximately $32 million of unused net operating loss carry forward's and almost $3,700,000 of unused investment credit. Westmoreland's pretax losses from operations for the years 1981, 1980, and 1979 were respectively, $15 million, $4½ million, and $6½ million.

It takes as much as a decade to bring a new deep mine into commercial production. These future energy realities depend on today's investment decisions. But it is difficult, if not impossible, to make a wise, sound investment and energy decision unless there is a consistent economic and tax policy.

One of the most pressing goals is to restore stability to our economy and instill more confidence in investment decisions. We believe the Economic Recovery Tax Act of 1981 is the basis of such a steady, sound course. It is designed in part to spur industrial expansion and to modernize what we are using.

Specific provisions of the act are targeted to capital-intensive, low-profit industries such as coal. The coal industry does not believe the administration's proposals are consistent with a steady course, and in some instances, these changes would leave industry in a worse investment and planning condition than before the act was passed.

We urge that the act be given more time to work its course. One year simply is not sufficient.

Mr. Chairman, in my detailed statement I have identified three other areas of concern which I ask the committee to consider. For the sake of brevity I will pass over them now. This concludes my testimony, Mr. Chairman, thank you.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL COAL ASSOCIATION

SUMMARY

The statement of the national coal association will include a background commentary on the economic state of the coal industry. In addition, our testimony will address five items:

(1) We urge rejection of the alternative minimum tax, and repeal of the existing add-on minimum tax, pointing out that because of depletion, the mining industry is hardest hit by either type of minimum tax.

(2) We strongly support the continuation of safe harbor leasing, without the negative influence of the alternative minimum tax. We urge that some companies have the desire to purchase new machinery and equipment, but simply do not have the investment funds. This is especially true of capital intensive, low-profit industries, such as coal mining.

(3) We urge retention of the business energy credits, noting that as an industry we gain little directly, but that our customers found them a valuable incentive for converting from oil or gas to coal.

(4) We ask for retention of the use of industrial development bonds—particularly as a means of financing pollution control facilities.

(5) We oppose accelerating corporate income tax payments, explaining the severe administrative burden that would result under the proposal.

INTRODUCTION

Mr. Chairman and members of the committee, I am Howard H. Frey, vice chairman and chief administrative officer of the Westmoreland Coal Company of Philadelphia, Pa.

Today I am speaking on behalf of the National Coal Association whose members account for over half of the United States coal production. Our members also include equipment manufacturers, transportation companies, coal exporters, consultants, and other coal-related industries.

I appreciate this opportunity to express the coal industry's views on the administration's budget proposal, specifically some tax related issues and their effect on the coal industry.

The coal industry's interest is in preserving an atmosphere of investment incentive, necessary for business growth and development, and consistent with the President's economic recovery program. Our Nation must have an ample supply of reasonably priced energy to fuel economic recovery. Coal, America's most abundant, most versatile, and lowest-priced energy resource will play an increasing role in achieving this goal. Experts predict that coal use is expected to double over the next 8 years and that it will become the United States leading export commodity.

The National Coal Association still expresses its support for President Reagan's economic recovery plan, even though it contains elements that would add to the coal industry's cost of doing business.

We were unenthusiastic, for example, about an increase in the black lung tax if it were not accompanied by a major reform of the program to eliminate flagrant abuses. Nor are we enthralled by the prospect of higher charges for Inland Waterway transportation if they unfairly affect the movement of coal.

Nevertheless, we supported the President's package, believing that ultimately it's in the national interest as well as the interest of the coal industry.

CAPITAL REQUIREMENTS OF THE COAL INDUSTRY

Policy statements by this and previous administrations positioned coal as the major future energy resource for our country. Our industry is expected to double production by 1990 and triple production by the end of the century. These production increases are needed to meet a growing need for coal, both here and abroad, as the world's free nations seek to reduce their dependence on OPEC oil.

These goals are reasonable, and they can be met—provided the means are available to finance the very substantial investment in machinery and equipment that will be required.

The U.S. coal industry today must address the realities of "constrained abundance." We can produce 100 million tons more coal annually than the market is taking. But we are confident this is a temporary condition and will change as more coal is used in our own country and overseas.

By conservative estimates, the coal industry will require more than three times our present capitalization—at least $50 billion for capital investment between now and 1990—and more than twice that amount by the year 2000.

New coal mines to meet future demand for our country's most abundant energy resource will provide tens of thousands of jobs, both directly in the coal-producing industry and indirectly in supporting industries such as equipment manufacturing, transportation, and sales.

But those jobs and all the spinoff economic benefits will not be realized unless coal producers can meet rapidly escalating capital costs.

First we need a frame of reference of the magnitude of capital investment required. It is generally accepted that the cost of a new underground mine—exclusive of the cost of the coal itself—is more than $55 per ton of annual production. This does not include the substantial administrative costs before startup. This includes surveys, feasibility studies and other such costs. Thus, a medium-size mine with a capacity of 1 million tons a year represents a capital investment of well over $55 million before 1 ton of coal is produced. Over the last 10 years production costs in the coal industry have risen by 100 percent.

Given these realities, the coal industry is deeply concerned about several aspects of the Reagan administration's proposed revisions of tax law and their effects. We believe these revisions will be damaging to the coal industry, and counter productive to the administration's goal of reviving our country's sagging economy.

THE ALTERNATIVE MINIMUM TAX

Mr. Chairman, the coal industry is facing large increases in production costs and declining profit margins at the very time when we must plan industry expansion. The highest degree of investment incentive possible is a necessity.

For these reasons we urge the repeal of the present corporate minimum tax which is being proposed. Both taxes, we believe are contrary to the goals of sound economic growth, but also work a special hardship on low-profit, capital-intensive industries, such as coal.

The minimum tax concept, for example, dilutes the tax incentives intended to help spur new investment, which is central to the Economic Recovery Tax Act of 1981. Mining is theoretically granted a 10-percent depletion allowance, but few coal producers can take full advantage of the incentives offered because of the 50 percent of net income limitation. From 1975 to 1980, our studies show that the coal industry's effective depletion rate dropped from just over 7 percent to just under 5 percent, illustrating the industry's declining profit margins.

By adding mining exploration and development costs as a preference item, many coal companies and other mining interests will be further starved for capital investment.

The existing add-on minimum tax is in itself onerous in that it substantially detracts from whatever benefits percentage depletion may allow. In the capital intensive mining industry, where capital outlays are mandatory in order to obtain the level of productivity that the country requires to fuel economic recovery, the add-on minimum tax substantially impedes the ability of such medium-sized mining companies as Westmoreland to develop their resources. The proposed alternative minimum tax would be even more detrimental in that it is proposed that mining exploration and development costs would be includable in the corporate minimum tax base for the deductions in excess of the amortization that would have been allowed on the straight-line basis over 10 years. Mining exploration and development costs represent capital expenditures from which no benefit will be derived perhaps for years on end. Most mining companies, operating on a low profit basis anyway, do deduct these costs as incurred. To treat these necessary expenditures as items of preference does not give cognizance to the realities of the problems confronting purely mining companies. As a case in point, for the years 1976 through 1981, Westmoreland and its operating subsidiaries incurred exploration and development costs amounting to over $47 million. Had these costs been subject to minimum tax, the company would have been required to pay out an additional $7 million in Federal income tax. The argument that the deduction of exploration and development costs as incurred is tax preferential is specious. Whether deducted in the year incurred or amortized over the 10-year period proposed, ultimately the corporation will recognize the same amount of deductions. Congress recently liberalized the tax depreciation rules by creating the ACR system, in order to create the opportunity to enhance capital investment. No thought has been given to including accelerated ACRs depreciation over straight-line on personal property as a tax preference item. To impose this penalty on purely mining companies, which traditionally, and especially within the last 5 years, have had low or no profits whatsoever, flies in the face of equity. If accelerated depreciation on personal property is not subject to minimum tax, it is absurd to impose this burden on an industry which certainly does not have the wherewithal to bear such a burden. The mining industry is not deriving an unfair advantage over other industries, but desperately needs these incentives in order to obtain the capital that it requires.

Treasury Secretary Regan has stated that many corporations pay little or no Federal income tax, despite reporting large profits to their shareholders. In the Treasury Department's view, this tax would apply to "corporate profits," that is, regular

taxable income plus selected incentives, and would apply only to those corporatio that pay very low regular rates of tax.

That may be so, but it would impact greatest on low profit, capital intensive i dustries including those mining coal.

I say again, the add-on corporate minimum tax should be repealed rather than l made more onerous by substituting the proposed alternative minimum tax.

SAFE HARBOR LEASING

Another proposal, the repeal of section 168(f)(8)—the so-called Safe Harbors Lea ing Provision—would render impotent the incentives package of the Economic R covery Tax Act of 1981 for many companies in the mining industry.

The coal industry believes that section 168(f)(8) makes the economic incentives (the Tax Act available equally to all companies, permitting investment strategie based on potential profitability and not on existing tax circumstances. Without suc a provision, identical investments can have far differing returns based on profitabi ity from older assets and other circumstances having little to do with the particula investment.

If the safe harbors leasing provision is repealed, the other incentives in the Ta Act could lead to uneven development activity in the economy and encourage mer ers which serve no other economic purpose except tax advantage. In essence, th Tax Act would then be strongly biased toward certain segments and certain classe of companies—at the expense of increased competition and broad-based growth.

Simply put, the coal industry supports the retention of the safe harbors leasin provision because it will stimulate investment in new mines and other facilities.

Last year the accelerated cost recovery system became law. That coupled with th investment tax credit provides an added incentive for companies to invest in produc tive machinery and equipment. However, for certain taxpayers the desire may exist but a lack of capital precludes the expansion and modernization of productive facili ties. This is particularly true for the capital-intensive, low-profit industries, such a coal mining.

I understand the logic behind the move to repeal this provision—that leasing is a subsidy for the inefficient. But we don't agree with the assumption.

I simply want to point out that some companies are paying low tax rates—no because they have low taxable income—but because they have low profit margins which is wholly consistent with reasonable tax policy.

Very briefly, let me comment on three other proposals before this committee business energy tax credits, tax-exempt industrial development bonds, and the accel eration of corporate tax payments.

Business energy credits are needed because they offer energy consumers an incen tive to weigh the benefits of converting from oil and natural gas to coal. We believe conversion to coal is clearly in the national interest for the reasons I stated earlier in my testimony.

Industrial development bonds are crucial to help electric utilities meet legal re quirements of retrofitting their plants with new pollution control equipment at a savings to the companies and to consumers.

We believe that IDB's are wholly consistent with the President's goals of energy development and environmental protection at the lowest feasible costs to all con sumers.

The coal industry doesn't support the acceleration of tax payments. By 1984 cur rent law will require that corporations pay currently 80 percent of their tax liabili ty. Due to uncertainties, estimating taxable income or the fact that taxable income reflects receivables from customers, any further acceleration of tax payments will result in additional costs and infinite administrative burdens.

In conclusion, Mr. Chairman, let me quote Peter Drucker, the well-known man agement expert: "Long-range planning," he said, "doesn't deal with future decisions, but with the future of present decisions.'

It takes as much as a decade to bring a new deep mine into commercial produc tion. These future energy realities depend on today's investment decisions. But it's difficult, if not impossible, to make a wise, sound investment and energy decision unless there is consistent economic and tax policy. One of the most pressing goals is to restore stability to our economy and instill more confidence in investment deci sions.

We believe the Economic Recovery Tax Act of 1981 is the basis for such a steady, sound course. It is designed in part to spur industrial expansion and to modernize what we are using. Specific provisions of the act are targeted to touch capital inten sive, low-profit industries, such as coal.

The coal industry doesn't believe the administration's proposals are consistent with a steady course. In some instances these changes would leave industry in a worse investment and planning condition than before the act was passed.

We urge that the act be given more time to work its course.

Mr. RUSSO. Thank you very much, Mr. Frey. Mr. Peabody, we have your entire statement which will be made a part of the record, if you wish to summarize it for the committee.

STATEMENT OF ROBERT B. PEABODY, PRESIDENT, AMERICAN IRON & STEEL INSTITUTE

Mr. PEABODY. Thank you, Mr. Chairman. My name is Robert Peabody, I am president of the American Iron & Steel Institute. I am appearing today on behalf of AISI, which represents 67 companies that manufacture about 92 percent of the steel made in the United States.

Since November 1980, individual companies in the steel industry have announced modernization programs which, in the aggregate, total more than $6.9 billion of capital investments. The expected return on these investments is a major factor in revitalizing the domestic steel industry. Steel company modernization programs would not have been undertaken without the strong belief that the President's tax and economic programs would remain intact and eventually be of substantial benefit to the industry.

We agree with the thrust of the President's program and believe that it must be given an opportunity to succeed. The most distressing feature of the administration's recent tax recommendations is the extent to which they offset the benefits of the Economic Recovery Tax Act before the incentive effects can even begin to be felt. The instability in tax policy which is inherent in this decision may very well erode the confidence of the business community in the administration's overall economic policies.

We are very concerned that the administration's proposal would reverse more than half of the business tax reductions granted in the period 1982 to 1985. One-third of the revenue increase would come from the alternative minimum tax which would impact especially hard on low-profit, capital-intensive companies which are in the greatest need of cash for investment in productive assets. The net effect of this reversal on the steel industry will almost certainly be a cancellation or a deferral of a major part of the announced modernization programs, at least under current economic conditions.

The proposal for an alternative minimum tax on corporations is a classic example of taking a bad law and making it worse. We agree with the administration that the current add-on minimum tax should be repealed. In 1978, the Senate Finance Committee reached the conclusion that the add-on minimum tax does not serve well either the goal of tax equity or the goal of encouraging capital formation and economic growth by means of tax incentives.

The proposed alternative minimum tax retains the counterproductive elements of the existing law, and adds several features which makes it even worse including the fact that a substantial alternative minimum tax could be incurred even though a company has no items of tax preference.

The Treasury estimates that about half of the revenues anticipated to be raised by the alternative minimum tax comes through a deferral of the application of carryover investment tax credits which are almost universally associated with low profit, capital-intensive companies. This provision is directly contrary to the clear intent of the Economic Recovery Tax Act to provide investment incentives. This impact is so severe in the steel industry that six companies representing about two-thirds of domestic raw steel production have reported that the aggregate increase in tax payments for the 3 years 1983–85 under the alternative minimum tax, would be $634 million. This tremendous cash drain does not come at a time of great prosperity; but rather, during or at the end of a period of severe economic decline.

The alternative minimum tax circumvents other existing statutes and selectively limits or repeals the incentives for which they were enacted. The concept of an alternative minimum tax is simply bad tax policy and it should be rejected.

The steel industry had been an early supporter of a capital cost recovery system, even though it was recognized that the major benefit of such a provision could not be realized until the industry became more profitable. We believe that the ACRS system is good tax policy which is beneficial for the country.

Congress realized that the ACRS provisions would provide little direct benefit to many low-profit, capital-intensive industries and further understood that some mechanism had to be found in order to permit these industries to participate more fully in the intended incentives.

The safe harbor leasing rules provide such a mechanism. In 1981, the steel industry generated some $250 million of cash through safe harbor leasing, and it was expected that the provision would be an important source of cash in the future. The administration has not formally suggested that the safe harbor leasing rules be repealed or amended, but we recognize that there is a growing pressure to either repeal or substantially modify them.

We urge this committee not to abandon the basic industries of the country now, when internally generated funds so essential to modernization plans, will be so severely curtailed. The situation in the steel industry is critical. The industry's operating level in the first quarter is only about 60 percent of capability and about 25 percent of the existing work force is either on layoff or working a short week. If any changes are necessary, they should deal only with the extreme cases and not alter the basic thrust of the provision.

It is worth noting in conclusion that most steel companies have stated that if the safe harbor leasing rules are repealed and an alternative minimum tax is enacted, their tax burdens would be substantially higher than they would have been before the Economic Recovery Tax Act.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ROBERT B. PEABODY, PRESIDENT, AMERICAN IRON & STEEL INSTITUTE

This statement is submitted on behalf of the American Iron and Steel Institute and its 67 domestic member companies, which together supply approximately 92%

of the iron and steel produced in the United States. The companies currently employ more than 350,000 workers in their iron and steel operations and have over 800,000 shareholders.

The American Iron and Steel Institute is in complete accord with the objectives of the Administration's overall economic program. The Institute is in favor of reduced Federal government involvement in the private sector, and particularly the Administration's efforts to get government spending under control in order to reduce the size of the Federal budget. Since November 1980 individual companies in the steel industry have announced modernization programs which in the aggregate total more than $6.9 billion of capital investments. This is greater than any amount for a comparable period since World War II. Investments for modernization in this magnitude, and the expected return in profits have been acknowledged by the President to be the key to revitalizing the steel industry.

The domestic steel industry has been weakened by many years of dumped and foreign subsidized steel imports, government price controls, enormous environmental control costs, and recently by two years of depressed steel demand. The steel company modernization programs would not have been undertaken without the strong belief that the variety of capital formation tools made available when the Congress adopted the President's tax and economic programs last year would eventually be of substantial benefit to the industry. Internally generated funds are not sufficient and external financing for steel plant purposes is not a practical alternative because of the industry's already heavy debt and uncertain future prospects.

REVERSAL OF LAST YEAR'S BUSINESS TAX CUTS IS ILL-CONCEIVED

The most distressing feature of the Administration's collective tax recommendations is the extent to which they offset the benefits of the Economic Recovery Tax Act before the incentive effects can even begin to be felt. The apparent instability in tax policy which is inherent in this decision may very well erode the confidence of the business community in the Administration's overall economic policies.

In relation to prior major tax bills, the Act was not overly generous to business in the first place with only about 20% of the total benefits in most years directed to business cuts. Therefore, when the Administration proposes that more than half of the reductions granted in the period FY82 to FY85 should be reversed, it is more than a cause for concern, it is alarming. This is especially true in the case of the steel industry since a major part of the revenue increase would come from the alternative minimum tax which would impact especially hard on low profit capital intensive companies, like steel. These industries received relatively little of the immediate benefit of the Economic Recovery Tax Act and would be asked to sacrifice a disproportionate amount.

The net effect of this reversal on the steel industry will almost certainly be a cancellation or deferral of a major part of the announced modernization program.

ALTERNATIVE MINIMUM TAX

The proposal by the Administration to impose an alternative minimum tax on corporations is a classic example of taking a bad law and making it worse. We can agree with the Administration that the current add-on minimum tax should be repealed as it applies to corporations. The Senate Finance Committee, in its report in connection with the Revenue Act of 1978, reached the conclusion that the add-on minimum tax "does not serve well either the goal of tax equity or the goal of encouraging capital formation and economic growth by means of incentives." Although the conclusion was reached in analyzing the individual minimum tax, it has equal applicability to corporations. It raises little revenue but takes a disproportionate share from the mining and steel industries. It selectively reduces the tax incentives intended to be provided by other carefully considered provisions of the tax code, and in some cases has rendered the intended incentives virtually worthless. Most importantly, it does not assure the extraction of a modest tax from prosperous corporations which may have some preference items as much as it does assure that selected corporations in cyclical industries are penalized in times of economic distress.

The proposed alternative minimum tax retains the counter-productive elements of the existing law and adds several features which make it even more objectionable. It has been claimed that a principal reason for this tax is to ensure that all corporations with large "economic incomes" will pay some tax. In examining the provisions, it is clear that the more adverse impact will continue to be on low profit capital intensive industries such as steel which are in the greatest need of cash for investment in productive assets. In addition, since a substantial alternative minimum tax

could be incurred even though a company has no items of tax preference, we are convinced that the tax is not intended to address excesses associated with tax shelter activities, which was the original intent of the minimum tax.

Rather, the primary objective seems to be to defer the application of unused investment tax credits which had been accumulated in prior years. In fact, the Treasury estimates that about half of the revenues anticipated to be raised by the alternative minimum tax come via this deferral. It is bad enough that this provision is directly contrary to the clear intent of the Economic Recovery Tax Act, even worse it impacts primarily on those companies with unused investment credits which are most universely low-profit capital intensive companies. This impact is so severe in the steel industry that six companies representing about two-thirds of the domestic raw steel production have reported that the aggregate increase in tax payments for the three years 1983–5 under the alternative minimum tax would be $634 million. This tremendous cash drain does not come at a time of great prosperity, but rather during or at the end of a period of severe economic decline. It is totally illogical to require the payment of a greater tax in times of economic recession, and then provide a credit to reduce future taxes in more prosperous times. Where the credit is deferred for a substantial period, it is effectively negated.

The Alternative Minimum Tax would circumvent other existing statutes and selectively limit the incentives for which they were enacted. The concept of an alternative minimum tax is simply bad tax policy and it should be rejected. If Congress has any concerns about the effectiveness, equity or propriety of any provisions of the tax law, it should deal with those provisions directly, and not indirectly through a minimum tax.

SAFE HARBOR LEASING

The steel industry had been an early and vocal supporter of the concept of a capital cost recovery system such as ACRS to replace the outdated accounting based theory of depreciation. This was true even though it was recognized that the major benefit of such a provision could not be realized until the industry became more profitable. We believed then, as now, that the ACRS system is good tax policy which is beneficial for the country, because it would stimulate investment, foster productivity, and in general improve economic conditions.

Congress realized that the ACRS provisions would provide little direct benefit to many low profit capital intensive industries, and further understood that some mechanism had to be found in order to permit these industries to participate more fully in the intended incentives. The safe harbor leasing rules which were ultimately adopted rather than investment tax credit refundability or transferability, provided such a mechanism. Not to have adopted these provisions would have meant that the incentives would have been available only to the established prosperous companies which were less in need, denying them to those companies which need the most help in restoring themselves to a profitable status.

In 1981 the steel industry generated some $250 million of cash through safe harbor leasing. It is expected that this amount would be nearly double in 1982, and that the provision would be an important source of cash in the future.

There are two important economic factors associated with safe harbor leasing that have not received a great deal of publicity. First, it is essentially a timing device which permits less profitable companies to receive an infusion of cash now rather than in the future. No additional deductions or credits are created in leases between taxable corporations. Second, it is frequently only a short-term phenomenon. Leasing is economically practical only for those companies which do not expect to use their investment tax credits fully within a two- or three-year period. As the leasing activity associated with the current year assets eliminates new investment tax credits, the backlog of unused credits may be worked down rather quickly to a point at which leasing is no longer desirable. The mechanism would have served its purpose of permitting less profitable companies to share in the incentives provided by ACRS until they return to profitability.

The Administration has not suggested that the safe harbor leasing rules be repealed or amended. We recognize that there is growing pressure; some political, some economic, to either repeal the safe harbor leasing provisions outright or to modify them so drastically, perhaps by reinstating provisions of the prior law, as to make the benefits essentially unavailable to the steel industry. We urge this Committee not to abandon the basic industries of the country in a time of recession, when internally-generated funds so essential to modernization plans will be so severely curtailed. The situation in the steel industry is critical. The industry's operat-

ing level in the first quarter is only about 60% of capability, and about 25% of the existing work force is either on layoff or working a short week.

If any changes are deemed to be necessary, they should be limited to restricting extreme applications, and should not alter the basic thrust of the provision. The law should not be amended in any way which would inhibit the ability of the steel industry to share in the incentives provided by the Economic Recovery Tax Act of 1981. It is worth noting that most steel companies have stated that if the safe harbor leasing rules are repealed and an alternative minimum tax is enacted, they would be substantially worse off than they would have been before enactment of the Economic Recovery Tax Act.

ENERGY TAX CREDITS

The decision of the Administration to seek repeal of the existing Energy Tax Credits is also not advisable. Many companies have already made plans or commitments which would insure an orderly transition following the termination of most of the energy credits at the end of 1982. Others have begun projects which take several years to complete, based on the understanding that the credits would be available in the future. Rather than terminate the credits, we would hope that this Committee would consider extending and expanding this incentive.

INDUSTRIAL DEVELOPMENT BOND FINANCING

Several steel companies have made extensive use of industrial development bond financing over the past several years to fund the substantial expenditures required for air and water pollution control. The current provisions represent a reasonable method of providing financing for these non-productive assets. The Administration's proposed changes would severely restrict this type of financing, thereby limiting the industry's ability to make expenditures for modernization as well as unproductive pollution control facilities. State and local governments are now being faced with decreasing federal revenues. In our opinion it is unlikely that local governmental units would have the ability to assume a burden of contributing to pollution control projects financed with industrial development bonds.

Mr. RUSSO. Thank you very much. We certainly appreciate the comments of all the members of the panel.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank the panel. May I ask, and any of you can respond, but if safe harbor leasing were to be repealed, what alternatives might exist to replace it?

Mr. Kelley, would you want to answer that?

Mr. KELLEY. If it were repealed?

Mr. DUNCAN. If we repealed safe harbor leasing, are there alternatives to replace it?

Mr. KELLEY. I think that the intention should be to retain a stimulation for capital investment. In view of our tax system as it now is structured, these companies that do have the limited profits and not the availability of income tax to credit would be pretty much precluded from having an available source for the stimulation of cash flow.

In the earlier panel, there was mentioned the refundability proposal, and that is always a possibility, but I gathered that it was Congress will not to get the Government involved in paybacks to taxpayers through a taxing system. I think that this is generally wise——

Mr. DUNCAN. What effect will it have on production in the coal fields? What effect would it have on production if safe harbor leasing is repealed?

Mr. FREY. I think it would affect coal production from the standpoint that it would slow down the replacement of equipment that is

wearing out. It would make it difficult to put in new and modern mines, which are tremendously expensive in their cost today. For instance, a long wall mining system runs about $10 million for one unit.

These matters would have to be set aside and the industry would do the best it could under the rules and regulations and the leasing policies that we lived under in previous times, but there are disadvantages to that and the incentive would not be there to go ahead.

Mr. DUNCAN. Short of total repeal, how could the alleged abuses that we have been reading about and hearing about be curtailed while still retaining some of the other desirable features of the act? Do you have any suggestions? That question was propounded to the other panel that was here a moment ago.

Mr. PEABODY. Mr. Duncan, that was spoken to, I guess for several hours, in the other panel.

Mr. DUNCAN. Do you agree with what was said?

Mr. PEABODY. Yes, sir, there are a variety of ways that Congress could act. I suspect, as someone observed earlier, abuses are in the eyes of the beholder. I would suggest that in reality it has acted precisely the way it was intended. If there are, for whatever reasons, including cosmetics, the need for changes, there were a variety of suggestions advanced and there will be more advanced in the future.

Mr. DUNCAN. Thank you, Mr. Chairman.

Thank you very much, gentlemen.

Mr. RUSSO. The gentleman from Pennsylvania, Mr. Bailey. He is now an expert in the field of bailing out distressed industries.

Mr. BAILEY. Thank you, Mr. Chairman.

I think most of you here know my views. I would like to, for purposes of the record, just get a few things down that I think would help clarify some of the misinformation surrounding leasing.

First of all, in terms of trying to deal with the perceptions that AISI was just referring to, if we were, let's say, to come in with a 50-percent cap, so to speak— that has been the terminology used— limiting purchasers to a 50-percent reduction in liability traceable to a safe harbor leasing transaction, could you support that? I would assume that you could.

I would also assume that it would not significantly affect the market in those transactions. That is No. 1.

Second, I asked the question this morning and I am wondering if you could reflect on it. If we could put some type of a limit, a bottom limit on the amount of the proceeds from the sale that would go to the nominal lessee, the recipient, the transferor, in effect, do you think that would leave enough room in the market?

Let's say we went at 90 percent. Would that leave sufficient flexibility in the market that there would still be demand? I would assume that it would. That might, I would suggest, dispel some of the criticism.

Third, if you would comment, please, on the importance of cash flow. Many people just do not understand this and much of the criticism in the press has been due to the fact that some folks got too big for their britches and maybe they should not have done that. They have given the whole effort a bad name, while we Members in Congress work so hard on these things.

The thing that is very important to know is that the initial transactions where there is a transference of investment tax credits that have been carried, let's say, for many years, not sufficient future tax liability to burn those credits up or to use them, in conjunction with a transfer, it really is a transfer mechanism we are talking about here, tax deductions often result in that higher discount rate, as we all know.

But the cash flow is vital to you and I wish you would comment, please, on how important that cash flow is. Most people do not understand that that is all you can really go to in order to make the investments, because you do not have anything to borrow against in many cases. A lot of people do not understand how vital this mechanism is to create jobs.

The last thing I am going to ask you to do for the future is to do everything you can to work out some kind of figures or statistics or whatever information you can have on the job creation. Now, that is difficult to do on the purchase of capital goods and reinvestment that Westmoreland Coal was referring to, that Mr. Frey was referring to earlier also, and I believe Mr. Kelley. Perhaps all of you have.

What kind of jobs do we get from this investment? Quite frankly, from a job creation point of view this is probably the most effective part of the entire tax program that was written.

Would you comment on those things in order: The discount rate, maybe a 90-percent limit, the cap, whether or not you can live with those things, and how you figure that 90-percent limit would affect the market in the transactions, in the leases; whether or not you have done any work on the job creation, the spinoff effect; and last, the importance of the transactions and why some of those discount rates, you know, that value retained by the third party purchaser has maybe gotten into the 15- to 20-percent range in order to give you cash flow, and how important that is to you.

Would you comment on those things?

Mr. BARRESE. I would like to say before I comment on them that I don't believe that any of the panelists this morning or the panelists that are sitting here have any objections to doing away with the abuses of the safe harbor leasing. And as far as the remedies of a 50-percent cap, I would think it would not affect the market. I am not expert to say that it definitely would not.

The 90-percent bottom limit proceeds to the lessor I have never even thought about.

As far as the importance of cash flow that you brought out, I mentioned my company received $34 million for leasing benefits last year, and this year I am sure it had some recognition in our board going ahead and approving a new mining project in Missouri.

Mr. BAILEY. That money went into the purchase and acquisition of capital goods?

Mr. BARRESE. That is right.

Mr. BAILEY. That is very important for people to know. It is job creating.

Mr. BARRESE. It will create jobs on the basis that it will be—Mr. Stark this morning said that California has no capital-intensive industries. We have some exploration that has been going on there

for many, many years, and the thing that has kept us from going ahead with a mining project there is exactly the cash flow.

Mr. RUSSO. The gentleman's time has expired. I believe that there are other members of the panel who probably wish to respond to that.

Mr. BAILEY. Yes, if they would like, Mr. Chairman.

Mr. RUSSO. We will extend the 5-minute period.

Mr. KELLEY. I would like to say that as far as any specific number is concerned, whether it is the 90 percent on the discount proposition or the 50-percent cap, I think that it may be a little more precise than we have given advanced thought to. I think that in these transactions there really is an involvement of the Federal Government in the process through the cash that is generated, and more investment is brought to bear in sectors where income can be generated. But we certainly don't have an objection to a limitation of some kind. In fact, it is part of our prepared testimony that there be a cap of some kind if that is deemed to be a control of the abuse.

In terms of cash flow, there is not an investment that our company goes into, other than those that are mandated by environmental control requirements or that type of thing, or furniture and fixtures that are not so measured. Our major income-producing investments are always evaluated on a discounted cash flow return on investment, and there is just no other way that an investment can be justified.

Mr. BAILEY. What I meant by that is that most participants in the industrial sector that you people occupy do not have available to you the alternative of going out there and borrowing, high prime aside. You simply do not have the ability to go out there and borrow for those kinds of investments sufficiently, and this is aiding your cash flow.

If someone says to you you don't need cash flow, go out there and borrow, you can't really do that, that is not realistic, particularly in the industries that you occupy. That is the point I am trying to make. That is not very well known.

Mr. BARRESE. Most of us are up to our debt limits.

Mr. BAILEY. That is what I mean. That is the point I am trying to emphasize. That is not well known.

Mr. FREY. Probably most of us have basic loans that have covenants in them that were conceived under better economic conditions for the mining industry and go back to 1974, 1975, 1976, even. That was not too bad. But what you speak of, Congressman Bailey, is the fact that cash flow from the earnings and the operation of that equipment and those mines is what pays off the debts incurred in the past, and if the rules get changed in the meantime, it makes it much more difficult to continue programs.

We all hope that we can work out the things that we have encumbered, but to expand and keep moving requires a positive playground, so to speak, playing field, as I heard mentioned this morning, in order to accomplish it.

Mr. PEABODY. Stated another way, it is providing cash that simply otherwise is not available.

Mr. BAILEY. Which you need for investment.

Mr. PEABODY. With respect to your point on the employment, you may recall that Republic Steel Corp. announced that the money it received from some safe harbor leasing transactions it engaged in went directly toward buying continuous casters that otherwise would not have been purchased. That is one of the prime needs in the domestic steel industry, and it not only provided employment but maintained it.

Mr. RUSSO. Mr. Moore.

Mr. MOORE. No questions; thank you.

Mr. RUSSO. I just have one or two questions, gentlemen. When you say that there would be a slowdown in equipment purchases, and I believe it was you who said this, Mr. Frey, if we did not have the safe harbor leasing, how would you be affected if we did have the first year total writeoff as it was proposed by the democratic alternative?

In other words, would you be able to expense out in the year you purchased the equipment the total amount of dollars of the equipment?

Mr. BAILEY. May I respond? I don't know if they are prepared for that question. One of the problems would still be the fact that they are in debt so high that with the cash flow available in order for them to make the investment in many cases that would not have been available.

Mr. BARRESE. Mr. Russo, any other additional writeoffs we would get the first year or any ACRS are of no benefit to us at this point in time because we don't have any profits.

Mr. RUSSO. OK.

Mr. FREY. I think I read our specific situation in the last 3 years and with pretax losses from operations for those 3 years and with additional tax deductions would not provide us with any relief.

Mr. RUSSO. Let me ask you fellows to comment. It seems to me that one of the big complaints we have is that there are some very profitable companies in this country that are using the safe harbor leasing to reduce their tax burden to almost zero. Some have done that.

Would it make more sense to, rather than have you sell your investment tax credits that you cannot use because you don't have enough income, have the Government subsidize you outright and give it to you right back on your tax returns? This way you get the $34 million that you need to purchase, to have the cash flow that you need, but some other major company in this country who would be paying the $34 million in taxes is not now reduced by $34 million.

Would that solve your problem?

Mr. BARRESE. Wouldn't this cause more of a perception problem?

Mr. RUSSO. We are always dealing in perceptions, but if your problem is cash flow, reducing or capping the amount that the company can obtain through the safe harbor leasing to me does not lessen the Government's burden whatsoever; it just spreads out the amount of companies who would be willing to get into this type of a venture.

So if you have $100 million of investment tax credit that you cannot use and a company is shifted only to 50 percent, for an example, can only use up to $50 million of your money, you will just

have to find another company to take the other $50 million or whatever that top cap is and the Government does not save any money whatsoever.

Part of the President's program is to try to recapture some dollars to offset this deficit. So what I am saying is that rather than allowing these companies to bargain with you about it, why don't you just bargain with the Federal Government right on the front end, and have them continue to pay their taxes and you get reduced taxes.

Mr. PEABODY. One of the panelists this morning observed, Mr. Russo, that there is a hidden factor that is of some moment and importance in these kinds of transactions pertinent to your point, and that is namely the policing that is done in the real world by the fact that the lessor, the General Electric, if you will, is going to be awfully certain that the equipment is there, is useful, is in place, and is workable.

Someone, on the other hand, from the Government, pushing aside all questions of desirability or subsidy, would have to perform that same function.

Mr. RUSSO. I will put my money on the IRS to make sure it was being done right. I think they have an effective record in doing that.

Mr. CONABLE. Could I make a comment on that? I do believe that if you go to refundability the tax credit will be available totally and regardless of the viability of the institution, that is of the transferor of the tax benefit. So one of the things we have learned, to our sorrow, is that there has to be a buyer; and if it is a buyer's market, it is not going to work, because the buyers do exercise some selectivity in the credits they buy. Of course in that situation where there is high risk, as there is right now because of Senator Dole's statement, and as a result of the existence of the minimum tax proposals of the administration, you have almost insured a ripoff because the credits are going to be sold for less than their economic value.

That does imply some degree of selectivity in the market, and it indicates to us quite clearly that we cannot leave it the way it is. We have to change it in some way or recertify it in some way so that people will have the confidence that they can buy an economic package at its value without any degree of risk involved in it.

I think that implicit, and that is the existence of some element of choice, selectivity. Clearly General Electric or anyone else is not going to want to deal with someone whose purchase of the capital assets is going to subject them to audit and possibly to problems relating to the folding up of an economic unit on the other side.

Mr. RUSSO. I just raise the question, Mr. Conable, that rather than getting a General Electric or some other company involved, maybe what we ought to do is just understand the problem and help those ailing industries by allowing them to write it off on their own returns. Then you allow General Electric and the other companies to——

Mr. CONABLE. How do they write it off on their own return less there is refundability?

Mr. RUSSO. That is what I am talking about.

Mr. CONABLE. If they are not paying taxes, they cannot write it off.

Mr. RUSSO. But they get to show it and then they can get a refund right from the Government and accept the fact that it is a subsidy. I only raise it as an issue for discussion.

Mr. CONABLE. Well, that raises all kinds of other issues in other types of tax proposals also. Whether or not we want to really expand the principle of refundability in the Tax Code, Milton Friedman to the contrary notwithstanding, is a philosophical question I am not ready to face.

Mr. RUSSO. That may be true. Do you have any other questions?

Mr. CONABLE. No.

Mr. KELLEY. I would like to make a comment. I mentioned earlier that I believe, and I think our association believes, although there were differences of opinion on the exact attractiveness of refundability, that the substitute of safe harbor leasing is a rather ingenious proposal, and I think it is superior to a system where your tax system has a two-way flow of money. I think your tax system should provide funds to the Government.

I also would like to say that in the transactions and the documents that support the safe harbor leasing transactions, that it is much more efficient as it works today than if there were Government involvement by any means, and particularly if you are speaking of the Internal Revenue Service being part of that system. The Internal Revenue Service really examines returns 3 to 5 years after they had been filed, and I do not see that being workable at all in substitution for safe harbor leasing.

Mr. RUSSO. Thank you very much, gentlemen.

We have had a long morning and we certainly appreciate your being with us. We appreciate your testimony.

The hearings will resume at 9:30 tomorrow morning, and on Friday morning the hearings will be at 9 rather than 9:30.

The committee is adjourned. Thank you very much.

[Whereupon, at 1 p.m., the committee was adjourned, to reconvene at 9:30 a.m., Thursday, April 1, 1982.]

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

THURSDAY, APRIL 1, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 9:40 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons presiding.

Mr. GIBBONS. Good morning, ladies and gentlemen. The meeting of the Ways and Means Committee on the President's proposals for tax increases will resume.

Our first witness this morning is Mr. Henry Reuss. Mr. Reuss, as we all know, is a very distinguished member of Congress. He has been the chairman of the Banking Committee, and voluntarily stepped down from that position so that others could have their experience in that job, and he has been chairman of the Joint Economic Committee. He is widely known throughout this country and throughout the world as being an expert on economic matters.

Mr. Reuss, we are happy to have you with us this morning.

Mr. ROUSSELOT. Would the gentleman yield, briefly?

Mr. GIBBONS. I would be happy to yield.

Mr. ROUSSELOT. My distinguished colleague is chairman of the Joint Economic Committee. Is that how you are appearing today?

STATEMENT OF HON. HENRY S. REUSS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN, AND CHAIRMAN, JOINT ECONOMIC COMMITTEE

Mr. REUSS. Yes. I appear in my individual capacity, and also as one of the signers of the unanimous report on the Democratic side.

I appreciate the opportunity to appear here today and to present my views on a sensible economic action program for the economy. The unanimous program of the 10 Democratic members of the Joint Economic Committee has been submitted to this great committee for its consideration.

Eight years ago Congress enacted the Budget Act, a great accomplishment which still offers our best hope of coordinating our tax and spending policies and of reducing deficits in the years ahead. Today that process is in danger.

The President has fundamentally undermined the process by submitting a budget document based upon unacceptable economic assumptions and unacceptable policies. He has created a stalemate by refusing to compromise on the two issues on which compromise

is imperative: The rate of increase in military expenditures and his tax program.

As the Wall Street Journal says in its top column this morning: "The President last night, while saying he is not inflexible, ruled out altering the proposed reduction in personal income taxes, which is part of Kemp-Roth."

He shows not the slightest interest in preserving the orderly function of congressional decisionmaking, nor in preserving the Nation from a breakdown of control over expenditures and taxation.

The orderly procedure by which Congress for a generation has supervised the issuing of the national debt is likewise endangered. The debt ceiling usually provided an easy opportunity for members to let off a little steam, but there always existed a broad-based consensus that we had to make extensions of the debt ceiling from time to time, as well as an agreement that the debt ceiling itself should not be elevated from a sideshow to becoming a central vehicle around which major policy decisions had to be made. It was agreed that we would be risking dangerous disruptions of the Government if we allowed the debt ceiling to go unrelieved.

Today, the sensible and cautious procedures of past years have been cast aside. The debt ceiling is the vehicle to which the major tax-budget decision of 1982 has to be attached. The President, through his intransigence, has made pointless the use of lesser and more flexible vehicles, which members who value orderly procedures would prefer. He has given us the choice between accepting the deficits implicit in his program in the debt ceiling legislation or rejecting them and casting the Government and the Nation into chaos.

Our only way out is to attach to the debt ceiling legislation a growth-promoting and deficit-reducing measure which will permit responsible legislators to face their consciences and their constituents.

The role of this committee thus must be to turn a potential instrument of mischief, namely the forthcoming vote on legislation to pierce the temporary debt ceiling, into an instrument which restores sanity to our fiscal policy and which thwarts the confrontation politics which the President is seeking to exploit.

Let the Congress, led by this committee, tell the President where the course of fiscal responsibility lies. Let us take a dramatic step to close the future budget deficit, and let us do it in a way in which the President cannot veto, by attaching our legislation to the debt ceiling extension bill and presenting that package to the President with the message that we do not intend to return to the issue should he veto our actions.

Then if the President should choose to flout the Congress, the onus for prolonged chaos in the affairs of Government would rest squarely with him. The American public and the world public would not, in my view, judge him kindly for it.

What single dramatic symbol of our return to fiscal common sense can we take? I am sure this committee has examined the alternatives carefully and that you know, as I know and as everyone who has studied the numbers knows, that there is only one tax action which is large enough, simple enough, efficient enough and

fair enough to do the job. We must repeal the excessive and unfair personal income tax reductions weighted toward the affluent, which goes into effect on July 1, 1983, the third year of Kemp-Roth.

If we do that, very little else is necessary, although repeal of tax leasing or of indexing could certainly be considered. If we do not repeal the July 1, 1983, measure, then no amount of legislative skill can assemble a mosaic of lesser tax changes necessary to achieve the same effect.

So the task of the committee, I suggest, is clear. It is to report an extension of the debt ceiling and a linked repeal of the July 1, 1983, tax reduction to the floor of the House. Passage is a necessary precondition to a first budget resolution, which must—or we shall see the budget process go down the drain—be passed by May 15.

People, including myself, are not going to vote for a budget resolution which neglects the revenue side of budget probity. The debt extension bill that I recommend, therefore, is an essential part of the process.

The Joint Economic Committee Democrats have unanimously presented to the Senate and House Budget Committees our four-point program designed to get the budget under control and end the recession. There are four simple points:

One, restrict military spending to a 13-percent increase, rather than the 18-percent increase the President wants; two, hold the line on nonmilitary spending in real terms; three, repeal the July 1, 1983, tax measure; and, four, instruct the Federal Reserve not to vitiate this budgetary action and thus to moderately loosen its present supertight monetary corset in which it has encased the money supply.

We put this four-point alternative to the Reagan program to data resources, and the results, compared to the Reagan program, are dramatic. Down, under our alternative, goes the deficit; down go interest rates; down goes unemployment.

The table at the end of my testimony sets forth the happy results. Under our program, this year the treasury bill rate goes down from its present 13.40 percent to 8.4 percent. The prime rate goes down to 12.8 percent. Two million people who are without jobs find jobs. Housing and automobiles are saved, and we get on a real growth pattern and a greatly reduced deficit.

Speed on the debt ceiling package, I suggest, is essential. Already the administration senses the danger to its misguided program by the threat of a confrontation over the debt ceiling. While the evidence is spotty, it looks as if the administration is engaging in subtle manipulation of the Treasury's finances to postpone from early May as late as it can the evil day of the debt ceiling confrontation.

A most unfair slowdown in refunding the billions in taxpayers' estimated tax overpayments may be one tempting way of postponing the day of reckoning. If necessary action on the debt ceiling can be deferred until the end of May, then corporate estimated tax payments which come in during June may make it unnecessary to act before July.

This would mean a continued unbroken stalemate on the budget that would threaten economic chaos. It is within this Committee's power to prevent the danger that looms ahead. You need not and

should not wait for the pressure of a debt ceiling deadline to build up before you act. You can act now. By so doing you can break the budget stalemate, you can save the budget process, you can lift the cloud of financial uncertainty which hangs over the future of our Government and the world. I urge you to do so.

We are now in April. The House will be in recess from April 7 through April 19. I respectfully urge this great committee to consider and report out a combined debt and taxes bill before we leave for our recess next week. Clause 1, lift the debt ceiling. Clause 2, repeal the July 1983 tax increase, with annual budgetary savings of $40 billion a year.

Let us take that home and tell our voters that we have started to act decisively to lower interest rates, lower the deficit and break the stalemate over the budget. Then, fortified by what I am confident will be a favorable reception, let us come back on April 20, bring it to the floor, pass it, send it over to the Senate, so that they can act well before the May 15 deadline so we can get together a responsible budget bill.

Then we can have the legislation in the President's hands for signature in the Rose Garden prior to May 15. By his action we will have made a budget resolution possible. We will have started to lead the Nation away from high interest rates, uncontrolled deficits and recession.

Now, if it be said that there is no precedent for forcing the ruler to sign a constructive measure, I would call the attention of the historically minded on this committee to something that happened 667 years ago, at the beginnings of Parliament. The barons of England were in a similar situation, with a very pleasant king. The historian Green describes King John as a man who possessed quickness, vivacity, cleverness, good humor, social charm. But in his inner soul, says the historian, he united in one mass selfishness.

Well, the barons were confronted by this and they met at Runnymede, and there he signed, quite unwillingly, the Great Charter. The historian recounts that after signing it, John threw himself upon the ground and gnawed sticks and straw in impotent rage.

Now, I do not think that anything like that is going to happen in the Rose Garden. But I do think that it would be a marvelous act if the barons of Congress should send to the President their version of Magna Carta, which would simply say, in language that is not too archaic: "No debt ceiling shall be pierced, save by the law of the land and by a staunching of the budget deficit." Something like that would go pretty good.

This is not quite a Magna Carta, but in terms of the welfare of the Nation and the free world, it would be an assertion of congressional responsibility which could do a lot for us.

I thank you very much for letting me express this view.

[The prepared statement follows:]

STATEMENT OF HON. HENRY S. REUSS, CHAIRMAN, JOINT ECONOMIC COMMITTEE

DEBT AND TAXES—A TIME FOR ACTION

I appreciate the opportunity to appear before you to present my views on a sensible economic action program for the economy and on a legislative leadership plan to end the current stalemate over the budget and the national debt. The unanimous program of the Democrats on the Joint Economic Committee, which includes recommendations on matters within the jurisdiction of this Committee, is herewith submitted for your consideration.

Eight years ago, Congress enacted the Budget Reform and Impoundment Control Act of 1974, which established the congressional budget process as we know it today. That was a great accomplishment, which offered, and still offers, the only hope of coordinating the development of tax and spending policy, and of achieving lower deficits in the years ahead.

Today, the congressional budget process is in danger. The President has fundamentally undermined the process by submitting a budget document based on unacceptable economic assumptions and unacceptable policies. He has created a stalemate by refusing to compromise on the two issues on which compromise is imperative: military expenditure and taxes. He shows not the slightest interest in preserving the orderly functioning of congressional decision-making, nor in preserving the Nation from a break-down of control over expenditures and taxation.

The orderly procedure by which Congress has for a generation supervised the issuing of the national debt is likewise endangered. In previous years, while the debt ceiling provided an easy opportunity for some Members of Congress to let off a little steam, there existed a broad-based consensus on the need to make extensions from time to time, as well as agreement that the debt ceiling itself should not be elevated from a sideshow to the central vehicle around which major decisions of policy must be made. To do so, it was agreed, would risk unseemly and even dangerous disruptions of the processes of government, and court the risk that a stalemate might develop which could prevent the government from functioning at all.

Today, the sensible and cautious procedures of past years have been cast aside. The debt ceiling is the vehicle to which the major tax-budget decision of 1982 must be attached. The President, through his intransigence, has made pointless the use of all lesser and more flexible vehicles, which Members who value orderly procedures would prefer. He has given us the choice between accepting the deficits implicit in his program in the debt ceiling legislation, or rejecting them and casting the government and the Nation into chaos.

Our only way out, our only hope for avoiding the worst, is to attach to the debt ceiling legislation a growth-promoting and deficit-reducing measure which will permit responsible legislators to face their consciences and their constituents.

The role of this Committee, then, must be to turn a potential instrument of mischief, disruption and disorder, namely, the forthcoming vote on legislation to pierce the temporary debt ceiling, into an instrument which restores sanity to our fiscal policy and which thwarts the confrontation politics which the President is seeking to exploit.

Let the Congress, led by this Committee, tell the President where the course of fiscal responsibility lies. Let us take a dramatic step to close the future budget deficit, and let us do it in a way which the President cannot veto: by attaching our legislation to the debt ceiling extender, and presenting that package to the President with a message that we do not intend to return to the issue should the President veto our action. Then, if the President should choose to flout us, the onus for prolonged chaos in the affairs of the Government would rest squarely with him. The American public would not judge him kindly for it.

What single measure, what dramatic symbol of our return to fiscal probity can we take? I am sure you have examined the alternatives as carefully as I have.

And you know, as I know, and as everyone who has studied the numbers knows, that there is only one tax action which is large enough, simple enough, efficient enough, and fair enough to do the job. We must repeal the excessive and unfair personal income tax reduction, weighted toward the wealthy, which goes into effect on July 1, 1983: the third year of Kemp-Roth.

If we do that, very little else is necessary, although certainly repeal of tax leasing and of indexing would also be desirable. If we don't repeal the July 1, 1983, measure, then in my judgement no amount of legislative and political skill can assemble the mosaic of lesser tax changes necessary to achieve the same effect.

So, the task of this Committee is clear: it is primarily to report a joint extension of the debt ceiling and a repeal of the July 1, 1983 tax reduction to the Floor of the House. Passage is a necessary precondition to a successful First Budget Resolution.

The Joint Economic Committee Democrats have presented to the Senate and House Budget Committees a 4-point program designed to get the budget under control and end the recession—(1) restricting the military spending increase to 5 percent in real terms; (2) holding the line on non-military spending in real terms; (3) the July 1, 1983, tax repealer here suggested; and (4) an instruction to the Federal Reserve to moderately loosen the supertight monetary corset in which it has encased the money supply.

The results of this 4-point alternative to the Reagan program, as projected by Data Resources, are dramatic—down goes the deficit, down go interest rates, down goes unemployment. The comparison is set forth at the end of this statement.

Speed on the debt ceiling package is essential. Already, the Administration senses the danger to its misguided program threatened by a confrontation over the debt ceiling. While evidence of action is spotty, the Administration certainly has every reason to seek a delay in the debt ceiling bill for as long as possible, and it may be engaging in subtle manipulation of the Treasury's finances to achieve this effect. A most unfair slow-down in refunding billions in taxpayers' overpayments on their estimates would be one tempting way of postponing the day of reckoning on the debt ceiling. If necessary action on the debt ceiling can be deferred until the end of May, as you know, corporate estimated tax payments which come in during June may make it unnecessary to act before July.

Such a delay of the debt ceiling would mean continued unbroken stalemate on the budget, stalemate that threatens economic chaos, and the distinct possibility that our congressional budget process would not survive. These are risks we cannot afford.

It is within this Committee's power to prevent the danger that looms ahead. You need not and should not wait for the pressure of a debt ceiling deadline to build up behind you before you act. You can and you should act now. By doing so, you can break the budget stalemate, save the budget process, and lift the cloud of financial uncertainty which hangs over the future of the United States Government. I urge you to do so.

Today is April 1, 1982. The House will be in recess from April 7, 1982, through April 19, 1982. I would urge you of the Committee on Ways and Means to report out a combined debt-and-taxes bill before we leave for our recess next week. Take it home and tell your voters that you have acted decisively and responsibly to lower interest rates, lower the deficit, and break the stalemate over the budget. Then, fortified by their reception, come back on April 20 and bring this measure to the Floor. When the House has acted, then the Senate can act. We can have our legislation in the President's hands and signed before the deadline of May 15, 1982, by which we must have acted on a First Concurrent Budget Resolution.

By our action, you will have made a Budget Resolution possible. By your action you will have started to lead us away from high interest rates, uncontrolled deficits, and recession.

COMPARISON OF FORECASTS OF RESULTS OF REAGAN PROGRAM AND JEC ALTERNATIVE PREPARED BY DATA RESOURCES, INC.

	1982	1983	1984
Real GNP growth (percent):			
Reagan [1]	−1.0	3.8	3.5
Alternative [2]	.5	6.6	3.7
Unemployment (percent):			
Reagan	9.1	8.6	7.9
Alternative	8.8	7.2	6.3
Deficit (fiscal year, billions of dollars):			
Reagan	117.1	110.8	104.3
Alternative	108.8	87.8	62.8
Housing starts (millions of units):			
Reagan	1.1	1.5	1.6
Alternative	1.3	2.0	1.9
Auto sales (millions of units):			
Reagan	8.7	9.7	10.4
Alternative	9.6	11.3	12.3
3-month Treasury bill rate (percent):			
Reagan	11.3	12.2	11.4
Alternative	8.4	10.4	7.7

COMPARISON OF FORECASTS OF RESULTS OF REAGAN PROGRAM AND JEC ALTERNATIVE PREPARED BY DATA RESOURCES, INC.—Continued

	1982	1983	1984
Consumer Price Index (percent change):			
Reagan	6.6	6.8	6.7
Alternative	6.7	7.5	7.4
Prime interest rate (percent):			
Reagan	15.1	15.5	14.1
Alternative	12.8	13.4	10.7

[1] Data Resources, Inc., analysis of Reagan policies, Feb. 10, 1982, Mar. 2, 1982.
[2] Data Resources, Inc. Feb. 22, 1982, simulation run of forecasting model, Mar. 17, 1982

Chairman ROSTENKOWSKI. I want to thank you, Mr. Chairman. It is always a pleasure to have you visit with us and give us the benefit of your sound learnings. I always enjoy my conversations with you as we walk to and from the House floor.

Are there any questions of Chairman Reuss? Mr. Duncan will inquire.

Mr. DUNCAN. I would like to welcome our colleague to the committee. You do not really think seriously that this committee or any other committee or the Congress could pass something before next Tuesday, do you?

Mr. REUSS. I did not suggest that, John. I said that action of a preliminary nature by this committee before the recess would give us all a chance to test the Nation on this. I think the test would be favorable. All is not lost if we do not, but I simply point out that we are 6 weeks from the moment of truth, and the date of crisis is May 16.

Mr. DUNCAN. Do you think it takes any great wisdom to try to balance the budget on the backs of the taxpayers? We have tried through the years and could not do it, and we found ourselves ending up with a 20- or 21-percent interest rate. And I think you must admit the interest rates are going down.

Mr. REUSS. No, I will not admit that. They are going up.

Mr. DUNCAN. Is it any great miracle? You know, I have elementary schoolchildren in my district that could vote to balance the budget on the backs of the taxpayers. But do you not think we have reached the point where we have to try something else?

Mr. REUSS. I believe, Mr. Duncan, that the budget must be controlled and the deficit brought down by attention to all elements. Domestic spending must be restrained, the rate of military increase must be cut, and the excessive reduction in revenues must also be brought under control.

Mr. DUNCAN. Why? Have we not done that before? We have seen since 1962 a budget of about $100 billion, and all the years, with all respect, that you had control, the expenditures went up, and the deficit now is over more than what the budget was in 1962.

Why have we not done that, instead of trying to work the miracles here this year? We tried about everything that you have mentioned and it did not work. How is it going to work this year, when it did not work before?

Mr. REUSS. Grievous mistakes were made, including by us Democrats, and grievously did we suffer for them by being tossed out in

1980. But that is no reason why we should not now try to be constructive and work up a program which is fair to all elements and which says that neither the affluent nor the poor nor the military shall entirely escape responsibility for bringing our budget under control.

That is my proposition. One can debate it, surely.

Mr. DUNCAN. Did you support the Democratic alternative last year on tax which was substantially close to the administration?

Mr. REUSS. I was one of the sponsors of the so-called Udall-Obey-Reuss alternative, which I vigorously supported. And had it passed, we would have avoided the recession and the huge deficits which now confront us.

Mr. DUNCAN. Now if we were to reduce the taxes or to take back the taxes, and then transfer the money to other social programs we have not gained a lot. Which programs do you plan to cut?

Mr. REUSS. The thing which we fed into the——

Mr. DUNCAN. If we refuse to give the money back to the taxpayers, what are the programs you plan to reduce?

Mr. REUSS. The social programs have been drastically reduced across the board.

Mr. DUNCAN. No, I said what did you plan? Are you for reducing student loans? Social security? We would like to have your list if you have the miracle that we——

Mr. REUSS. Fine. I will give it to you right now.

The proposition which, when put into the Data Resources computers, achieved such a dramatic result was simply that we hold the line in real terms on all nonmilitary spending. I would go farther than that. It does not bother me a bit to take a look at the so-called entitlements, at the double COLA-ization of certain retirees, at the total exemption from taxation of social security payments.

Mr. DUNCAN. Would you go farther than taking a look at them? I take it then that you——

Mr. REUSS. Take a look and act on them.

Mr. DUNCAN [continuing]. Are opposed to the cost-of-living increases, the student loans, and most all the increases?

Mr. REUSS. Take a look and act on them immediately, if those, such as this committee, can agree. And I do not have any difficulty saying right now that to me nothing is sacred.

Mr. DUNCAN. We have been looking at them for 18 years since I have been here, but it all went wrong. What you are advocating is really to go back to where we were.

Mr. REUSS. What I am saying is that this Nation is approaching a crisis, and that crisis will infect the entire free world. That crisis is brewing because by May 15 we must achieve a first budget resolution. We cannot, in my judgment, achieve such a resolution without a tax component.

Mr. DUNCAN. Do you not think there has been something accomplished by bringing the interest rates down from 20 to 16 percent? Does that not please you at all? That is what the administration inherited.

Mr. REUSS. I find that of little comfort, since the mortgage rate has actually gone up and since businessmen great and small tell me that the present structure of interest rates prohibits their making the kind of capital investment they desperately need.

Mr. DUNCAN. You are not hopeful they will go back up, are you? You do not want to return to where we were?

Mr. REUSS. If we adopt the program that I suggest, interest rates would stay down.

Mr. DUNCAN. Thank you. Thank you, Mr. Chairman. I enjoyed the colloquy.

Chairman ROSTENKOWSKI. Are there further questions? Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Reuss, we hear a lot about balancing the budget on the backs of the taxpayers. Let me ask you a question. If we do not balance it on the backs of the taxpayers, on whom are we going to balance the budget?

Mr. REUSS. As I said before, I think the budget must be brought under control on the backs of all of us. That includes the backs of an overinflated military that cannot possibly spend all of the percentage increases in the President's military budget.

That includes, I regret to say, workers and poor people who have already borne an inordinate share of the burden. And now to suggest that the more fortunate among us do a fair share of the budget balancing act, I do not think is radical.

Mr. DOWNEY. I do not, either. I welcome your support for that notion and your leadership. I am also interested in your reaction to the AFL-CIO proposal for the tax bill for fiscal years 1983 and 1984. What they are suggesting is that we cap the tax return of individuals who earn over $40,000, which for a family of two would be about $700 in 1983 and another $700 in 1984. And that everyone up to $40,000 would get their 10 percent across-the-board cut. They would eliminate the indexing provision, as well as the safe harbor leasing and a whole host of other things.

How does that as an idea strike you? I am concerned—let me add this notion parenthetically—that my party, our party, should not be perceived either politically or substantively as being the ones robbing the middle income and working class people of their small tax return, in light of the fact that many of these people are not going to see any wage increases in the next year or so. So that potentially the only real income, if it is real income, that they would get would be in the form of this tax return.

Mr. REUSS. I am very sympathetic, Mr. Downey, to that principle of equity in general and to the AFL-CIO's program in particular. But we are confronted here with a stubborn fact: Action must be had by May 15. There are so many eminent Republicans who have agreed that the elimination of that July 1, 1983, last act of Kemp-Roth is the way to go that I believe that is politically doable.

When 1983 comes around, let this great committee, as it does every year, take a look at the economic situation. If the economy is doing so well that tax reductions are then possible, let us enact them on as equitable a basis as possible. But meanwhile, rich and poor in this country cannot go on with the kind of destructive economic climate we now have. We must bring it under control.

Mr. DOWNEY. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Are there any further questions? Mr. Rousselot will inquire.

Mr. ROUSSELOT. Mr. Chairman, I am delighted to see the chairman of our Joint Economic Committee here. As the gentleman has already indicated, the Republicans on the committee had a minority report, and now we are almost evenly divided in the Senate on the Joint Economic Committee. But there are points to be made on tax policy and on savings on the expenditures side.

I think when you testified before the Senate Budget Committee, you stated that you agreed with many of the savings on the spending side that had been recommended by the committee. Is that not the case?

Mr. REUSS. Particularly the military.

Let me say, on the Joint Economic Committee, that there is not only one Republican view counterposed to the unanimous Democratic view, but three, all interesting.

Mr. ROUSSELOT. And all should be called to the attention of this fine committee. Three different tax policies, right?

Mr. REUSS. Regrettably, yes.

Mr. ROUSSELOT. Mr. Chairman, you are very definite that you want to increase taxes July 1, 1983.

Mr. REUSS. No. That is a phrase used by the President which is——

Mr. ROUSSELOT. Well, it is also used by me now.

Mr. REUSS [continuing]. A little disingenuous. Taxes are what they now are. Congress has tentatively passed a future tax decrease on July 1, 1983. I thought it was a mistake. I think it is now a disaster and we should undo that.

I think the gentleman from California will find that taxpayers, while they do not like to pay taxes, prefer to have jobs and prefer to have reasonable interest rates. And those I have talked to, high and lowly placed, think it would be a splendid idea to get rid of that incubus.

Mr. ROUSSELOT. You wish to eliminate the indexing that is to begin in 1985? You favor bracket creep?

Mr. REUSS. The elimination of indexing is not in the program I present. The sole tax measure needed is the repeal of the July 1, 1983, projected tax increase.

Mr. ROUSSELOT. But I think you stated in the Senate committee that if you had your way you would eliminate indexing.

Mr. REUSS. Right. But I do not think that will fly, and hence I do not recommend it. There are many other things—safe harbor, oil depletion, all-savers certificates—fill the cornucopia high. I will welcome it. But I do not think you can get it through. And your leaders—Conable, Rostenkowski—have a political task to perform, and I would not want to load them up with more than they can deliver.

Mr. ROUSSELOT. But you would favor eliminating indexing?

Mr. REUSS. I think indexing as passed——

Mr. ROUSSELOT. Yes, I see.

Mr. REUSS [continuing]. Was a mistake, because instead of concentrating on relief for the lowest bracket income taxpayers, it projects its indexing right up——

Mr. ROUSSELOT. Oh, it is across the board.

Mr. REUSS [continuing]. The tax bracket and thus insures, not that the average family can keep its market basket, which it

should, but that all Americans continue the inflation of their wealth and their assets. That is not going to work.

Mr. ROUSSELOT. So you favor bracket creep?

Mr. REUSS. So, in time, before we go the way of Minnesota, which is now close to bankruptcy and which has seen a splendid Republican Governor, our friend and former colleague Al Quie, retire in the face of an exploded indexing, I think we should take a look at it, but not today and not before May 15.

Mr. ROUSSELOT. You approve, then, of continuing to let inflation push taxpayers into higher and higher brackets, right?

Mr. REUSS. No. I just said I favor relief from that pushing for lower income taxpayers. But I do not think higher income taxpayers need to be guaranteed an inflation of their wealth, world without end.

Mr. ROUSSELOT. Well, that is called selective bracket creep. I appreciate the gentleman——

Chairman ROSTENKOWSKI. Are there any further questions?

[No response.]

Chairman ROSTENKOWSKI. If not, thank you, Mr. Chairman.

The committee welcomes the Governor of the State of Illinois, His Excellency Hugh Carey. [Laughter.]

Mr. RANGEL. The State of "Illinois"?

Chairman ROSTENKOWSKI. I just promoted him.

Mr. CONABLE. Governor, there is a certain provincialism around here that we have to fight all the time. [Laughter.]

Chairman ROSTENKOWSKI. Hugh, welcome to the committee. It is always nice to have you back. There are several of us who had the privilege of serving with you on this committee and remember the fine record that you established in the House. With that introduction, the Chair will recognize Mr. Rangel.

Mr. RANGEL. Well, a lot of your friends and supporters in New York, Governor, were wondering what you were going to do politically, and now that my chairman has let it out of the bag, we wish you luck wherever you decide to run for Governor. [Laughter.]

STATEMENT OF HON. HUGH CAREY, GOVERNOR OF THE STATE OF NEW YORK

Governor CAREY. Thank you very much.

Mr. DOWNEY. Mr. Chairman?

Chairman ROSTENKOWSKI. Mr. Downey is recognized.

Mr. DOWNEY. I would also like to welcome our Governor. I suspect that now he has declared he is not a candidate, he hears what a wonderful Governor he was. The fact is, he was a wonderful Governor, is a wonderful Governor, and personally I am sorry that he is not seeking reelection.

Governor CAREY. Mr. Chairman, can I go ahead while I am ahead? [Laughter.]

Well, Mr. Chairman, it is a great pleasure to return to this committee and to discuss with you some of the difficult decisions concerning tax policy and economic recovery that again confront the Congress. It is now clear that the promises made by the President last year for a strong economic recovery through massive tax cuts were misleading. Indeed, as I warned this committee last year, and

as I have stated before other committees several times since then, the President's program cannot work.

The supply side vision that has guided the President is fundamentally flawed. I repeat my warnings today: We cannot engineer the recovery of the national economy through massive tax cuts while a large part of the Federal budget remains totally out of control.

In New York, in our State, we cut taxes by $2.5 billion over 5 years, but only after we had controlled all aspects of State spending. This fiscal prudence restored investor confidence and helped reduce unemployment. As a result of this rebuilding effort, we have been spared the worst ravages of the current recession. We are better off than most States in the Northeast and Midwest, but that is not good enough.

President Reagan has failed to follow this successful example, the example of New York, an example that editorials in the Wall Street Journal have held up as a model for Federal policy three times in the past year.

If the President is genuinely concerned about getting the budget under control, he must give up his singleminded focus on cutting programs that help the poor and needy, and on reducing investments in both human resources and capital plant. Defense, entitlement programs, pension and debt service costs account for more than two-thirds of all Federal spending. So without a serious strategy for controlling these costs, the administration's claims about exorcising the devils of excessive government spending will quickly prove ephemeral.

I do not deny that there are ways to reduce spending in the areas that constitute the remaining third of the budget. We can reduce domestic spending prudently and humanely, and in testimony before other committees of the House I have suggested a number of ways in which it could be done.

But we must recognize that programs like AFDC, food stamps, CETA, or mass transit capital assistance are not the cause of our current budgetary problems, and reductions in programs like these will not solve our problems in the long run.

The same is true of tax policy. The President has presented a series of proposals for revenue enhancement, designed to reduce what seems to be an ever-growing deficit. Some of them are reasonable; others could be made acceptable if substantially modified; still others are totally ill-conceived. But none of them addresses the basic problems with which this committee must deal.

The minimum corporate tax, tax-exempt revenue bonds, and tax incentives for energy conservation are not the real sources of the Federal Government's fiscal problem. Far more significant than any of these is the tax-reduction program enacted last year, which we now see may have permanently put the structure of Federal Government financing out of balance, without delivering any of the proposed economic benefits.

Until the President is willing to reconsider his position on the Economic Recovery Tax Act, miscellaneous revenue enhancement measures, even if justified in themselves, will be of limited value.

In my testimony today, I will therefore address both the specific revenue enhancement measures proposed by the administration

and then briefly the broader issues of tax policy that the Committee on Ways and Means will need to consider in the coming months.

First, the administration's revenue enhancement program. The administration is proposing several measures to raise revenues in fiscal year 1983. I will discuss three of the most important: The proposal to limit revenue bond financing; the corporate minimum tax; and the proposal to repeal all business energy tax credits.

Limiting tax-exempt bond financing. The administration proposes to limit the revenue lost through the issue of tax-exempt bond financing and to reduce what they perceive as abuses through several changes, including requiring that: one, enterprises receiving revenue bond financing to surrender the benefits of accelerated cost recovery; two, all projects be approved by State and local governments; and three, after 1985 all projects would have to receive a financial commitment from the State or local government.

I cannot conceive of a worse time to attack revenue bond financing. Interest rates are, of course, at record levels, in large part because of the enormous deficits created by the President's own program. Business bankruptcies are at their highest levels since the depression.

Many States, such as New York, have developed extremely effective small issue programs. Our job development authority, the State's principal user of small issues, has done an exemplary job of using industrial revenue bonds to stimulate economic development, create jobs, and provide small businesses with sorely needed access to equity.

The New York program is unusual among State authorities issuing tax-exempt industrial bonds. Rather than serve as a conduit for loans between a private borrower and a lender, JDA functions as a State industrial development bank, obtaining funds through the sale of State-guaranteed bonds and notes and making loans to small businesses whose credit is not strong enough to finance a project through conventional sources.

Today, more than 90,000 New Yorkers are working in companies that have benefited from JDA loans. These loans have produced $600 million of private sector investment in buildings, machinery, and equipment. This record is especially notable given that the average loan has been less than $200,000. I recommend New York State's program to this committee as a model of effective small business financing.

The proposed requirement that businesses must choose between the benefits of tax-exempt financing and the tax savings from accelerated depreciation allowances enacted last year would be particularly harmful to the States' efforts to develop and rehabilitate low- and moderate-income housing.

Another major limitation proposed by Treasury would require that governments using IRB's make a financial contribution or commitment to the project. The demand for cash contributions is particularly inappropriate when State and local governments are trying to cope with massive Federal budget cuts, and with revenue losses resulting from full or partial conformity with Federal tax cuts. Moreover, more than 30 States' constitutions, including New

York's, deny State and local governments the power to donate or lend money or credit to nongovernmental entities.

The Treasury proposal would restrict the yield issuers of IRB's could earn on bonds proceeds during the temporary construction period and on reserve funds. This new arbitrage limitation would jeopardize the financing of issuing authorities and in some cases would make the projects for housing, hospitals, and nursing homes unworkable. We urge the committee to reject this provision.

The Treasury proposal also requires IRB issues to be registered, and that issuance of obligations must be reported by State and local governments to the Internal Revenue Service. However, registration requirements will unduly increase operational and administrative burdens, increasing the interest rate on each issue by as much as one-quarter to one-half a percentage point. The Congress should reject this proposal in its present form.

Finally, the proposals advanced by the Treasury would require the highest elected official or legislative body to approve the issuance of IRB's after a public hearing. As an alternative, the public approval requirement could be met by a vote referendum on the bonds to be issued for the particular project.

This proposal fails to recognize extensive review and approval procedures currently now in place in many States. Given the current condition of the tax-exempt markets, strong incentives exist for executive review of IRB projects by designated officials. However, the nature of this executive review is, for the most part, appropriately left to the individual States.

I urge Congress to reject this provision.

The arguments made against revenue bond financing do not stand up to close scrutiny. The administration has argued that the program costs the Treasury billions of dollars in tax revenues. Yet many studies, including one by Norman Ture, now Assistant Secretary of the Treasury, have found that these lower interest loans actually generate revenues by stimulating investment and creating jobs.

I recognize that there are abuses with small issue IRB's. Working with my fellow Governors in the Northeast, we have developed an alternative program to terminate use of industrial revenue bonds for commercial projects except in certain distressed areas. In addition, the proposal would exclude certain research and development expenditures when calculating the capital expenditure limits on small issue IDB financial projects.

We call for public notice of a proposed financing and favor a requirement that the issuance of IRB's be approved at public meetings. Finally, we would require all State and local development authorities to file with the Treasury a report specifying the annual volume of IDB's issued by each authority.

One proposal I do endorse is the initiative to restore umbrella financing for small issues. On August 24, 1981, the Internal Revenue Service issued revenue ruling 31-216, a ruling that prohibited the issuance of composite or umbrella bonds for small issues. Umbrella financing allows the fixed costs of issuing bonds to be spread over several issues, reducing borrowing costs to small businesses, exactly those companies needing IRB assistance. I urge Congress to support the administration's change of heart.

These proposals regarding small issue IDB's would address many of the concerns raised by the administration without unduly delaying projects or unnecessarily increasing cost, and would maintain revenue bonding as a vital State and local tool for economic recovery.

The President's minimum corporate tax proposal is a hastily developed response to the growing awareness by the American people that the National Economic Recovery Tax Act had left many highly profitable companies with no tax liabilities. However, instead of removing the cause of this problem—net leasing—and reforming the inequitable accelerated cost recovery system, the administration has proposed an ill-designed minimum corporate tax.

Of particular concern to New York State is the provision that would include interest on indebtedness to purchase or carry tax-exempt securities in the calculation of the minimum tax.

The demand for institutional investment in municipal bonds has been reduced by the new tax law, particularly the expansion of leasing tax shelters and the accelerated depreciation schedules, which will enhance the rate of return on alternative investments. Moreover, in recent years banks and casualty insurance companies have either had low profits or found other means of shielding income from taxation, resulting in a cutback in institutional purchase of tax-exempt bonds.

Given these market conditions, it is ill-advised for the administration to propose the imposition of a minimum tax on the interest or borrowing arbitrarily allocated to tax-exempt security holdings. The Public Securities Association estimates that this provision will cost State and local governments approximately $1 billion in increased interest costs in the first year alone.

I therefore urge this committee to reject the administration's proposal for a minimum corporate income tax in its present form.

As to business energy tax credits, the administration proposes the early termination of certain business energy investment tax credits. The President stated that tax credits are not necessary because markets will allocate energy resources efficiently and that the energy tax incentives distort the allocation of energy resources. He believes that decontrolled prices of oil and natural gas will be an adequate incentive to achieve energy conservation and increased utilization of renewable resources.

Although the President believes that the free market principle should apply to energy conservation investment, he continues to support Federal subsidies for the oil and nuclear power industries. Continued Government subsidies for energy production, while at the same time eliminating incentives that decrease energy consumption or which encourage the development of alternative, renewable energy, is seriously mistaken policy.

There are some revenue enhancement initiatives that I strongly endorse. The increased reliance on user fees for inland waterway transportation, general aviation, and recreational boating will insure the more efficient use of these resources and reduce inequitable subsidies. The rail system in the Northeast has long been penalized by the massive subsidies to waterborne freight.

I see no reason why the American taxpayer should subsidize those individuals fortunate enough to own boats and aircraft. But

the administration's major initiatives are simply further examples of a consistent policy to penalize small business and increase Federal revenues directly at the expense of State and local governments.

Speaking toward a rational tax policy, the Economic Recovery Tax Act of 1981 provided huge and ill-designed cuts in income taxes, together with special giveaways for influential industries, together with a few real improvements in the Federal Tax Code.

Changes in the structure of Federal taxation were needed. But the remedies proposed by the President and those adopted by Congress have proven to be dangerous mistakes. Our first step must be to restore fiscal stability and a sound economy to correct these errors.

As to personal income taxes, the income tax cuts enacted last year must be modified to reduce the revenue losss, to provide effective incentives for savings, and to distribute more equitably the benefits of tax reduction. I suggest we must take the following steps immediately:

Drop the third-year tax cut from the legislation at least until economic and fiscal conditions justify it;

Eliminate the provision for automatic indexing of the tax structure that takes effect in 1985;

Stretch the tax brackets for households earning less than $40,000 a year so that the generous increase in disposable income bestowed this year is distributed more equitably.

These reforms would help close the deficit, while increasing the equity of our tax system.

As to business taxes. Congress must also act immediately to correct the most glaring inequities of the business tax cuts enacted last year. Most significant of these are the new net leasing provisions. The wholesale transfer of credits and depreciation allowances by highly profitable companies is clearly not an effective incentive and is creating a hemorrhage of revenues for both State and Federal Governments.

I recognize that our present tax incentives do not reach many companies that need help because they do not have taxable income. Therefore, I propose that we retain net leasing for mass transit rolling stock, but abolish it for private corporate investments and replace it with partial refundability of the investment tax credit.

We must also close down inefficient and wasteful tax provisions such as the foreign tax credit.

Third, we should impose a tax on imported oil. The present glut threatens to slow the conservation effort and to increase our dependence on foreign oil. A fee of $5 per barrel on imported oil at this time would have a negligible effect on price, as world prices are declining. It would raise revenues of $17.5 billion according to estimates by the Congressional Budget Office.

These are short-term measures. In the long run we must restructure taxes to encourage growth. In my testimony last year before this committee I outlined a four-point tax reform strategy. The major components are: First year cost recovery for depreciation; integration of the corporate and personal income tax; special tax credits for distressed neighborhoods; and tax credits for hiring the disadvantaged.

These initiatives will provide effective incentives for productive investment.

In conclusion, although the President's program for economic recovery is clearly not working, his response to the deepening recession and growing economic distress is to offer more of the same for fiscal year 1983. We cannot restore the Nation's economy until the President balances a true commitment to expenditure containment with a rational and equitable tax reduction policy.

I do not believe that a balanced budget is a prerequisite to economic recovery, but I know that uncontrolled deficits will preclude the resumption of economic growth. New York, our State, followed a balanced and successful approach that I urge the administration to emulate. I have outlined a tax strategy that will restore the confidence of the business community and will restore equity and efficiency to the tax system. It is a strategy we can ill afford to ignore.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF GOV. HUGH L. CAREY, STATE OF NEW YORK

Mr. Chairman, distinguished members of the Committee, it is always a pleasure to return to this committee and to discuss with you some of the difficult decisions concerning tax policy and economic recovery that again confront the Congress.

It is now clear that the promises made last year by the President for instant economic recovery through massive tax cuts were misleading. Indeed, as I warned this Committee last year, and as I have stated before other committees several times since then, the President's program cannot work. The supply side vision that has guided the President is fundamentally flawed. I based this warning on my experience in helping steer New York State out of economic and fiscal crises which were every bit as severe as those now facing the nation.

I repeat my warning today. We cannot engineer the recovery of the national economy through massive tax cuts while a large part of the federal budget remains totally out of control. In New York we cut taxes by $2.5 billion over five years, but only after we had controlled all aspects of State spending. This fiscal prudence restored investor confidence, and helped reduce unemployment and generate a rate of personal income growth well above the national average. As a result of this rebuilding effort, we have been spared the worst ravages of the current recession.

President Reagan has failed to follow this successful example—an example that editorials in the Wall Street Journal have held up as a model for federal policy three times in the past year. The President has created deficits that are unsupportable this year and that will actually grow as the economy recovers. As he did last year, he is trying to hide these deficits by fiscal sleight-of-hand, but long unemployment lines, rising business bankruptcies, and a depressed stock market are ample evidence that you cannot fool all of the people all of the time.

If the President is genuinely concerned about getting the budget under control, he must give up his single-minded focus on cutting programs that help the poor, and on reducing investments in both human resources and capital plant. Defense, social security, pension and debt service costs account for more than two thirds of all federal spending. Without a serious strategy for controlling these costs, the Administration's claims about exorcising the devils of excessive government spending will quickly prove ephemeral.

I do not deny that there are ways to reduce spending in those areas that constitute the remaining third of the budget. We can reduce domestic spending prudently and humanely and in testimony before other committees of the House I have suggested a number of ways in which that could be done. But we must recognize that programs like AFDC, Food Stamps, CETA, or mass transit capital assistance are not the cause of our current budgetary problem—and reductions in programs like these will not solve our problem in the long run.

The same is true of tax policy. The President has presented a series of proposals for "revenue enhancement," designed to reduce what seems to be an ever-growing deficit. Some of them are reasonable; others could be made acceptable if substantially modified; still others are totally ill-conceived. But none of them addresses the basic problem with which this Committee must deal. The minimum corporate tax,

tax-exempt revenue bonds, tax incentives for energy conservation are not the real sources of the federal government's fiscal problem. Far more significant than any of these is the tax reduction program enacted last year, which we now see may have permanently put the structure of federal government financing out of balance, without delivering any of the promised economic benefits. Until the President is willing to reconsider his position on the Economic Recovery Tax Act, miscellaneous "revenue enhancement" measures, even if justified in themselves, will be of limited value.

In my testimony today, I will therefore address both the specific "revenue enhancement" measures proposed by the Administration, and then briefly, the broader issues of tax policy that the Committee on Ways and Means will need to consider in the coming months.

I. THE ADMINISTRATION'S REVENUE ENHANCEMENT PROGRAM

The Administration is proposing several measures to raise revenues in fiscal year 1983. I will discuss three of the most important: (1) the proposal to limit revenue bond financing; (2) the corporate minimum tax; and (3) the proposal to repeal all business energy tax credits.

These proposals are being advanced at a time when municipal bonds are suffering from intense downward market pressures generated by the Administration's own fiscal and monetary policy. Municipal bonds that were selling at an average of 9.9 percent last year are now averaging 13 percent. The corresponding dramatic increases in debt service for state and local governments further reduce severely limited government resources that provide essential government services. The traditional differential of thirty percent to thirty-five percent between municipal bonds and comparable taxable bonds has been narrowed to sixteen percent. The budget cuts enacted last year and those promised for next year will reduce federal aid to state and local governments by more than $20 billion. Many of the programs most severely affected by last year's action were capital related programs for housing, transportation, environmental conservation, and urban development. Reductions in federal support for these programs necessarily increase pressure on state and local governments to expand current capital projects financing by tax-exempt borrowing, resulting in an increase in supply of municipal and industrial revenue bonds.

The Economic Recovery Tax Act of 1981 is also causing higher rates of interest for municipal bonds compared to taxable securities. The reduction in the personal tax marginal rates, especially the lowering of the top bracket from seventy to fifty percent, the associated reduction in capital gains rate, the expansion of personal income sheltering opportunities in individual retirement savings plans, have substantially reduced the demand for tax-exempt securities in the household market.

Limiting tax exempt bond financing.—The Administration proposes to limit the revenue lost through the issue of tax exempt bond financing and to reduce what they perceive as "abuses" through several changes including requiring that: 1) enterprises receiving revenue bond financing to surrender the benefits of Accelerated Cost Recovery; 2) all projects be approved by state and local governments; and 3) after 1985, all projects would have to receive a financial commitment from the state or local government.

While I have no problem with requiring a "sign-off" by a local public official, the other proposals are needlessly destructive and inequitable, and do not address the real abuses that have occurred in the use of this type of financing.

I cannot conceive of a worse time to attack revenue bond financing. Interest rates are at record levels, in large part because of the enormous deficits created by the President's own program. If interest rates were at four percent, then we could discuss ways of cutting back on this program. With real interest rates at well over 12 percent—a peacetime record—cutting back is economic madness. Business bankruptcies are at their highest levels since the depression. These measures would needlessly raise the cost of public capital at the same time that federal support for both public works and industrial development is being cut back. The "new federalism" would give to state and local governments a much greater responsibility for funding and administering economic development programs. Why is the Administration removing an effective and critical tool for local development?

Many states such as New York have developed extremely effective small issue programs. Our Job Development Authority, the State's principal user of small issues, has done an exemplary job of using industrial revenue bonds to stimulate economic development, create jobs and provide small businesses with sorely needed access to equity. The New York program is unusual among state authorities issuing tax-exempt industrial bonds. Rather than serve as a conduit for loans between a pri-

vate borrower and a lender, JDA functions as a State industrial development bank, obtaining funds through the sale of state-guaranteed bonds and notes and making loans to small businesses whose credit is not strong enough to finance a project through conventional sources. Today, more than 90,000 New Yorkers are working in companies that have benefited from JDA loans. These loans have produced $600 million of private sector investment in buildings, machinery and equipment. This record is especially notable, given that the average loan has been less than $200,000. I recommend New York State's program to this Committee as a model of effective small business financing.

The proposed requirement that businesses must choose between the benefits of tax-exempt financing and the tax savings from accelerated depreciation allowances enacted last year would be particularly harmful to the states' efforts to develop and rehabilitate low and moderate income housing. The New York State Housing Finance Agency, created in 1960 as the vehicle for financing low and middle income multi-family housing through the issuance of tax-exempt securities, has used industrial revenue bonds to provide financing for more than 67,000 units of low and middle income housing. This year it will assist in the development or rehabilitation of more than 4,500 housing units. However, unless developers are allowed access to below market financing provided by HFA and the new depreciation rates, these projects will terminate simply because they are no longer economically feasible with low and middle income rent levels. In addition, with the proposed elimination of Section 8 subsidies for low and middle income housing, the interest rate differential of tax-exempt financing is the only remaining method of bringing rents down to affordable levels for these families.

Another major limitation proposed by Treasury would require that governments using IRBs make a financial contribution or commitment to the project. The demand for cash contributions is particularly inappropriate when state and local governments are trying to cope with massive federal budget cuts, and with revenue losses resulting from full or partial conformity with federal tax cuts. Moreover, more than 30 states' constitutions, including New York's, deny state and local governments the power to donate or lend money or credit to non-governmental entities. These prohibitions are well-grounded in public policy and should not be altered to facilitate the use of IRBs. Moreover, it is unlikely that many states would or could alter their constitutions before 1986.

In addition to such constitutional limitations, this proposal would impose another financial strain on state and local governments already severely burdened by the reduction in federal funds. This proposal ignores the substantial contribution already made to projects financed by IDBs financed through: real estate tax abatement, sales tax exemptions, medicaid payments, tax exemption on the interest or municipal bonds, and direct state appropriations. This provision must be rejected by Congress.

The Treasury proposal would restrict the yield issuers of IRBs could earn on bond proceeds during the temporary construction period and on reserve funds. This new arbitrage limitation would jeopardize the financing of issuing authorities and, in some cases, would make the projects for housing, hospitals and nursing homes unworkable.

In the construction of low income housing where construction delays are common, the inability to earn interest on funds during construction periods make such projects financially infeasible. In New York State, arbitrage earnings have traditionally been used to set up new capital construction programs, cover losses, or other bond issues, enhance the viability of projects that are rate-sensitive, reduce the total amount of bonds issued—thereby reducing the total cost to the borrower, cover the cost of issuance and establish necessary reserves.

Without this flexibility many construction and modernization projects would not go forward. I urge the Committee to reject this provision.

The Treasury proposal also requires IRBs issues to be registered, and that issuance of obligations must be reported by state and local governments to the Internal Revenue Service. I support the reporting requirement as a means of improved monitoring of the use of IRBs. However, registration requirements will unduly increase operational and administrative burdens, increasing the interest rate on each issue by as much as one-quarter to one-half a percentage point. The corresponding increase in debt service over the life of the bonds could be prohibitive. Congress should reject this proposal in its present form.

Finally, the proposals advanced by the Treasury would require the highest elected official or legislative body to approve the issuance of IRBs after a public hearing. As an alternative, the public approval requirement could be met by a vote referendum on the bonds to be issued for the particular project.

This proposal fails to recognize extensive review and approval procedures currently in place in many states. In New York State the Public Authorities Control Board, established in 1976, must approve public authorities' issuance of debt and additional financing for new or expanded capital projects. All hospital projects must be approved by health officials at both the state and local levels after public meetings. State University projects must be approved by the State Legislature and housing projects must obtain the approval of the State Commissioner of Housing.

Given the current condition of the tax-exempt markets, strong incentives exist for executive review of IRB projects by designated officials. However, the nature of this executive review is, for the most part, appropriately left to the individual states. If this proposal were applied at the federal level, the President or Congress would have to approve each issuance of debt by the Federal Financing Bank. A procedure wholly unacceptable on its face.

I urge Congress to reject this provision.

The arguments made against revenue bond financing do not stand up to close scrutiny. The Administration has argued that the program costs the Treasury billions of dollars in tax revenues. Yet many studies, including one by Norman Ture, now Assistant Secretary of the Treasury, have found that these lower interest loans actually generate revenues by stimulating investment and creating jobs.

The Administration also claims that revenue bonds are expanding rapidly and driving up the cost of borrowing in the tax exempt market. Yet this argument ignores the fact that the real pressure on tax exempt rates has come from massive federal borrowing, and from the All-Savers Certificate, a program many times the size of revenue bonds.

To claim that a company receiving revenue bond financing and depreciating under ACRS is somehow "double-dipping" is pure verbal gymnastics. ACRS is simply the way we treat depreciation. Large corporations enjoy the advantages of other incentives such as the foreign tax credit, special depletion allowances, and a host of other generous benefits. Industrial revenue bonds is a simple and inexpensive way of reducing the cost of borrowing to small business. I therefore urge Congress to reject this proposal.

Some critics contend that IRBs have subsidized major corporations. This has happened, but citing it as a general weakness of the program distorts the facts. The Congressional Budget Office found that ninety percent of all IRBs were for small, closely held firms that are not listed on the stock exchange. Only seven percent went to Fortune 1000 companies, and half of those issues were below $1 million. It has been proposed to limit financing to businesses with capital expenditures of less than $20 million over six years and less than $10 million in IDBs outstanding after issuances of the bonds. Although efforts to limit small issues to small business development is a laudable goal, this provision would adversely affect high technology firms of all sizes. These firms operate in a highly competitive evolving industry in which equipment must be updated constantly at high cost. The need for such a limitation must be questioned since so small a share of IRBs go to large businesses.

I recognize that there are abuses with small issue IRBs. Working with my fellow Governors in the Northeast, we have developed an alternative proposal that would call for the termination of the use of industrial development bonds for commercial projects except in certain distressed areas. In addition, the proposal would exclude certain research and development expenditures when calculating the capital expenditure limits on small issue IDB financial projects. We call for public notice of a proposed financing and favor a requirement that the issuance of IRBs be approved at public meetings. Finally we would require all state and local development authorities to file with the Treasury a report specifying the annual volume of IDBs issued by each authority.

One proposal I do endorse is the initiative to restore umbrella financing for small issues. On August 24, 1981 the Internal Revenue Service issued revenue ruling 81-216, a ruling that prohibited the issuance of composite or umbrella bonds for small issues. Umbrella financing allows the fixed costs of issuing bonds to be spread over several issues, reducing borrowing costs to small business, exactly those companies needing IRB assistance. I urge Congress to support the Administration's change of heart.

These proposals regarding small issue IDBs would address many of the concerns raised by the Administration without unduly delaying projects or unnecessarily increasing cost, and would maintain revenue bonding as a vital state and local tool for economic recovery.

The minimum corporate tax.—The President's minimum corporate tax proposal is a hastily developed response to the growing awareness by the American people that the National Economic Recovery Tax Act had left many highly profitable companies

with no tax liabilities. However, instead of removing the cause of this problem—net leasing—and reforming the inequitable accelerated cost recovery system, the Administration has proposed an ill-designed minimum corporate tax.

Of particular concern to New York State is the provision that would include interest on indebtedness to purchase or carry tax exempt securities in the calculation of a minimum tax.

The demand for institutional investment in municipal bonds has been reduced by the new tax law, particularly the expansion of leasing tax shelters and the accelerated depreciation schedules which will enhance the rate of return on alternative investments. Moreover, in recent years, banks and casualty insurance companies have either had low profits or found other means of shielding income from taxation, resulting in a cutback in institutional purchase of tax-exempt bonds.

Given these market conditions, it is ill-advised for the Administration to propose the imposition of a minimum tax on the interest or borrowing arbitrarily allocated to tax-exempt security holdings. Efforts to maintain commercial banks' demand for municipal securities that currently hold approximately forty-five percent of outstanding municipal debt will be undermined by the Administration's proposal. The Public Securities Association estimates that this provision will cost state and local governments approximately $1 billion in increased interest costs in the first year alone.

Equally disturbing is the proposal's retroactive application to all outstanding tax-exempt securities. Retroactive application of this provision will create uncertainty among all investors, further eroding the market for these activities.

I therefore urge this Committee to reject the Administration's proposal for a minimum corporate income tax in its present form.

Business energy tax credits.—The Administration proposes the early termination of certain business energy investment tax credits. Specifically, credits available for expanding the use of solar, wind, ocean thermal and geothermal energy equipment; small hydroelectric facilities; and biomass energy equipment scheduled to expire in 1985 would be terminated at the end of 1982.

In addition, it is proposed to terminate provisions of the Windfall Profits Tax Act of 1980 allowing states and local governments to issue tax-exempt industrial development bonds to finance low-head hydro facilities, facilities which produce steam or alcohol from solid waste, and certain state programs for energy conservation.

The President justified these measures by stating that tax credits are not necessary because markets will allocate energy resources efficiently. He further states that energy tax incentives improperly distort the allocation of energy resources. He believes that decontrolled prices of oil and natural gas will be an adequate incentive to achieve energy conservation and increased utilization of renewable resources.

Although the President believes the "free market" principle should apply to energy conservation investment, he continues to support federal subsidies for the petroleum industry in the form of intangible drilling expenses and the depletion allowance. The dramatic increase in the selling price of domestic oil since the creation of these special tax provisions made these additional subsidies superfluous. Moreover, more than $12 billion of additional tax relief for the oil industry was enacted last year as part of the Economic Recovery Tax Act. If the President is truly committed to a free market approach to energy supply and conservation, he should call for the termination of special subsidies to the oil industry generating more than $17 billion in additional federal revenues.

Free market distortions are also created by substantial federal subsidies to the nuclear energy industry. Termination of these subsidies would help reduce federal spending.

In short, continued government subsidies for energy production, while at the same time eliminating incentives which decrease energy consumption or which encourage the development of alternative, renewable energy, is seriously mistaken policy. It would also promote development in energy producing states at the expense of the rest of the nation. Price decontrol of petroleum has swollen the severance tax revenues in the energy producing states. The energy poor Northeast and Midwest are footing the bill. If we maintain incentives for the production of conventional fuels, we must also recognize the need for incentives for energy conservation and renewable resource development. As a region, we cannot produce our way out of the energy crisis, nor can we go-it-alone without a commitment by Congress to a more evenly balanced national energy policy.

The need for business incentives for investment in conservation and renewable resources will become increasingly important if the Administration's budget proposals to reduce federal funding for conservation spending by 84 percent and renewable energy programs by 70 percent are enacted.

The loss of the federal business energy investment tax credits would be a substantial financial loss for New York businesses and according to our calculations would jeopardize the installation of over 500 Megawatts of electricity generating capacity and over 55 Trillion British Thermal Units of energy from renewable resources in New York State.

We estimate that, since 1978, New York businesses will have claimed energy tax credits worth $145.9 million by the end of 1982. An additional $68.4 million will be claimed by the end of 1986. Over these next years, these tax credits would assist New York business in making $885.5 million worth of investment in renewable energy and energy conservation in the State, thus lessening our dependence on foreign oil, strengthening our economy and preserving and creating jobs.

In summary, I believe the Reagan energy tax credit proposals should not be enacted. There is no free marketplace in the energy economy due to long-standing federal tax supports for petroleum and hefty budget appropriations for nuclear energy which President Reagan proposes to continue. History has shown our vulnerability to actions by the OPEC cartel. This nation's energy problems and our dangerous overdependence on foreign oil will not just go away by terminating a few energy tax credits, which are insignificant when compared to other business incentives. I recommend that those credits which will expire at the end of this year be extended to permit additional time for these technologies to establish themselves. In addition, the energy tax credits scheduled to expire in 1905 should not be terminated prematurely.

There are some revenue enhancement initiatives that I strongly endorse. The increased reliance on user fees for inland waterway transportation, general aviation and recreational boating will ensure more efficient use of these resources and reduce inequitable subsidies. The rail system in the Northeast has long been penalized by the massive subsidies to waterborn freight. And I see no reason why the American taxpayer should subsidize those individuals fortunate enough to own boats and aircraft. But the Administration's major initiatives are simply further examples of a consistent policy to penalize small business and to increase federal revenues directly at the expense of state and local governments.

II. TOWARD A RATIONAL TAX POLICY

The Economic Recovery Tax Act of 1981 provided huge and ill-designed cuts in income taxes together with special giveaways for influential industries, together with a few real improvements in the federal tax code. And the tax cuts were not accompanied by an effective program of expenditure containment. The result is enormous federal deficit, and little promise of the economic growth advertised by the Administration.

Changes in the structure of federal taxation were needed. Our tax system does discourage productive investment and savings; and it does encourage diversion of capital into unproductive tax shelters. But the remedies proposed by the President, and those adopted by Congress have proved to be dangerous mistakes. Our first step in restoring fiscal stability and a sound economy must be to correct those errors. Starting this year, we must begin a multi-year program of tax reform, restructuring and reduction that must be phased in as federal spending is effectively and fairly reduced.

Personal income taxes.—The income tax cuts enacted last year must be modified to reduce the revenue losses, to provide effective incentives for saving, and to distribute more equitably the benefits of tax reduction.

The National Economic Recovery Tax Act of 1981 contained massive cuts in personal income taxes—but cuts that serve mainly to create enormous deficits and provide windfall gains to the rich. The working American whose labor provides the country with its food, consumer goods, and shelter has no place at this moveable feast. We must take the following steps immediately:

Drop the third year tax cut from the legislation at least until economic and fiscal conditions justify it.

Eliminate the provision for automatic indexing of the tax structure that takes effect in 1985. For the federal government to commit itself to indexing before the budget has been brought under control and the deficit sharply reduced, if not eliminated, is wildly irresponsible.

Stretch the tax brackets for households earning less than $40,000 a year so that the generous increase in disposable income bestowed this year is distributed more equitably.

Convert standard deductions into standard credits. Instead of deducting from taxable income $1,000 for each dependent, we should offer a tax credit of $230. This

leaves tax revenues unchanged, but ensures that a child is worth the same in reduced taxes to all households, regardless of income. There is no reason why an American born to a high-income household should reduce that household's taxes by $500, while one born to a working household may be worth only $100.

These reforms would help close the deficit, while increasing the equity of our tax system.

Business taxes.—Congress must also act immediately to correct the most glaring inequities of the business tax cuts enacted last year. Most significant of these are the new "net leasing" provisions. The wholesale transfer of credits and depreciation allowances by highly profitable companies is clearly not an effective incentive and is creating a hemorrhage of revenues for both state and federal governments.

Even the Wall Street Journal has recognized that last year's leasing provisions were a mistake. In a recent editorial, the Journal described the new law as "a dud." I recognize that our present tax incentives do not reach many companies that need help, because they do not have taxable income. However, net leasing also benefits highly profitable companies with large accumulated tax credits. Therefore, I propose that we retain net leasing for mass transit rolling stock, but abolish it for private corporate investments and replace it with partial refundability of the investment tax credit. To ensure that credit rich corporations do not benefit, only corporations that have suspended dividend payments would be eligible. This would ensure that the program is tightly targeted to the most needy companies.

We must also close down inefficient and wasteful tax provisions such as the Foreign Tax Credit. Severance taxes paid to foreign oil producers should be treated as a business expense not as a credit that forces the Ameican taxpayer to subsidize the accumulation of wealth by OPEC countries.

Third, we should impose a tax on imported oil. The present glut threatens to slow the conservation effort and to increase our dependence on foreign oil. A fee of $5 per barrel on imported oil at this time would have a negligible effect on price, as world prices are declining. It would raise revenues of $17.5 billion according to estimates by the Congressional Budget Office. Our allies all have high excise taxes on oil and this tax would be a major step in convincing them of our commitment to energy security in the future.

These are short term measures. In the long run we must restructure taxes to encourage growth through a four-point program. The major components are: First Year Cost Recovery for depreciation; integration of the corporate and personal income tax; special tax credits for distressed neighborhoods; and tax credits for hiring the disadvantaged.

Depreciation.—We must replace the inequitable and rash Accelerated Cost Recovery Program with a rational treatment of depreciation—the First Year Capital Recovery (FYCR) program designed by Professor Dale Jorgenson at Harvard. FYCR maintains the concept of useful asset life, and therefore does not artificially subsidize certain types of equipment. It allows the business to deduct the present value of economic depreciation in the same year that the asset is acquired and so "inflation-proofs" the value of allowances.

Integration of corporate and personal income taxes.—Our present tax system taxes dividend income twice—first through the corporate income tax, then through the personal income tax. This raises the cost of equity capital, encourages retained earnings that deny small companies equal access to capital, and reduces the rewards to investing for more working households who do not have the benefit of highly-paid accountants to guide their investment decisions. The high rate of retained earnings also concentrates investment decisions in the Fortune 500 companies. Corporations seek investments, mergers and acquisitions for tax reasons rather than those that yield a real economic return. Conglomerates milk subsidiaries for their tax benefits and then close them down, devastating local communities.

Integration would not abolish the corporate income tax. Instead, the shareholders would be subject to tax on their pro-rated share of total corporate taxable income—including both distributed and undistributed profits. The corporation would, in effect, be withholding personal income taxes for its stockholders. The after-tax rate of return for a household in the 25 percent tax bracket would be greatly increased, encouraging a much broader ownership of American industry.

Investment Tax Credits.—The switch to First Year Cost Recovery would include repeal of the present federal investment tax credit. In their place, we should offer special tax credits for four purposes: First, to stimulate research and development; second, to encourage firms to hire the economically disadvantaged; third, to encourage the construction of low income housing; and fourth, as part of a targeted job development program for low income communities.

To help our declining low income areas, I propose a targeted job development program. This would provide incentives for job creation. Each state could designate a series of targeted job development areas which would include about fifteen to twenty percent of their poorest residents. Firms within these areas would receive two major tax benefits: 1) a broad, ten percent investment tax credit extended to machinery and structures; and 2) a fifty percent add on to the Targeted Jobs Tax Credit which provides credits to firms hiring the economically disadvantaged. Congress cannot let the TJTC expire this year as the Administration wishes. As we cut back on all other job development incentives for the disadvantaged, we must retain this program. Recent reforms have corrected the faults that earlier studies pointed to. These credits should be partially refundable to new and small businesses who lack tax liabilities against which to use normal credits.

CONCLUSION

Although the President's program for economic recovery is clearly not working, his response to the deepening recession and growing economic distress is to offer more of the same for fiscal year 1983. We cannot restore the nation's economy until the President balances a true commitment to expenditure containment with a rational and equitable tax reduction. I do not believe that a balanced budget is a prerequisite to economic recovery, but I know that uncontrolled deficits will preclude the resumption of economic growth.

New York followed a balanced and successful approach that I urge the Administration to emulate. I have outlined a tax strategy that will restore the confidence of the business community and will restore equity and efficiency to the tax system. It is a strategy we can ill-afford to ignore.

Chairman ROSTENKOWSKI. Thank you, Governor, for an excellent statement. It is always rewarding to share views with you.

Are there any questions of Governor Carey?

Mr. GIBBONS. Mr. Chairman, I do not have a question, but I want to welcome Governor Carey——

Governor CAREY. Mr. Gibbons, it is good to see you.

Mr. GIBBONS [continuing]. A very distinguished American and my good friend. Glad to have you back here.

Governor CAREY. Glad to be with you, Mr. Gibbons.

Mr. RANGEL. I would thank the Governor for his thoughtful statement, and we do hope it will serve as a guideline for this committee's deliberations.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire

Mr. DUNCAN. I would also like to welcome our former good colleague and member of the committee.

Do you not think that the $100 billion in debt service on the debts that prior Congresses have helped establish has anything to do with the deficit we have today?

Governor CAREY. There is no question that debt service as a segment of the budget is getting out of control.

Mr. DUNCAN. You relate it all to the present administration, but the debt service is related——

Governor CAREY. Mr. Duncan, do not test my memory, because back in 1965 it was President Lyndon Johnson I recall that brought us all over to the White House and said that he wanted to hold the budget at $100 billion, and the debt limit somewhere around $100 billion and in return for that he took swift action to put a surcharge on the income tax to prevent a deficit. Now, let us go 15 years back for $100 billion.

When did we accumulate these deficits? President Nixon had some enormous deficits. I remember Secretary Connally coming up to this committee and saying we had to hold down the deficit. Yes, there were deficits back then, but nothing has grown in terms of a

deficit in the short-term as large as these deficits. We never had interest rates currently going——

Mr. DUNCAN. I would say that the prior administrations' deficits—that is, the $100 billion—has to have something to do with the deficit today.

Governor CAREY. Mr. Duncan, $20 billion of that $100 billion was the Vietnam war peace dividend we never received. Remember that peace dividend?

Mr. DUNCAN. I know where it came from. You just did not mentioned it in your statement. I thank you very much.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

Governor, it seems to me that the Treasury's proposals on tax-exempt financing really reverse some of the decisions that were made, that State and local governments should be responsible for some financing and the Federal Government for others. Could you embellish your testimony on what negative impact the Treasury proposals would have on our State if we had to live with these new arbitrage requirements and the new public hearing requirements as well?

As I understand it, our State already goes through a very rigorous proposal to make sure that there are not frivolous purposes for tax exempt financing.

Governor CAREY. New York State does, and so do other issuers. Our fear is that by excessive regulation, as you say, a totally diverse posture from the deregulation posture aimed at private industry, there would be excessive regulation. And the provision requiring the hearing process, coming from on high from the Federal Government, gives those who would be opposed to even small groups issuing revenue bonds, a forum which they would utilize to delay the issuance. And it is important to be able to get issue bonds into the market at the appropriate time.

We do have a hearing process. I am not against that. But sometimes you have to move the issue and get it going. If you lose the market, if you do not have, as we do in our State, the job development authority able to borrow a larger sum and then subdivide the borrowing into small amounts for small borrowers, we lose the impetus of small business efforts in high technology to increase development of jobs.

We have increased our jobs in New York in the last 5 years by 500,000. We know that fully 75 percent of those came from those small type industries who are the beneficiaries of this kind of financing. So on the job sector, in this climate with unemployment at terribly unacceptable levels across the entire Northeast-Midwest corridor and elsewhere, this is no time to hamper the industrial development bonds which are used to stimulate the job market.

At the same time, you do know we face a frightful shortage of housing and shelter, and that industry is terribly recessed. If we have any hope there, we want to use industrial revenue bonds to help restore the stock of housing starts. So in two ways, employment and housing, it is going the wrong direction.

Mr. DOWNEY. I think the point you made, and it needs to be emphasized, is that you and local governments have faced a kind of triple whammy. Not only have grants-in-aid been reduced as a Fed-

eral share, but you piggyback the tax changes of the last year, so you lose revenue there as well. And then when you conclude with all of the leasing provisions that have taken effect, and the President's new proposals on the corporate minimum tax, doesn't that really lead to a devastated bond market for municipal finance? Will it be possible to ever do municipal finance at reasonable rates of interest, in your opinion?

Governor CAREY. Well, there have been those experts in the field who have said that possibly the municipal bond market, the bond market for local and State agency securities, might disappear in this country, as it has in Great Britain. We do not want that to happen.

We do not want to borrow. But given the fact that we have had terrible losses in the budgets due to the effect of the Accelerated Cost Recovery Act and conformity to that act, we have had excessive losses in revenues due to high unemployment. We have got to keep our hospitals going. We have got to continue to build out the State agencies for mental retardation. And if we cannot borrow for those things or, for that matter, for prison and deployment of people to fight crime, we are in very sad shape.

Mr. DOWNEY. Thank you.

Chairman ROSTENKOWSKI. Are there any further questions?

Mr. Bailey will inquire.

Mr. BAILEY. Thank you, Mr. Chairman.

Governor, I just want to thank you very much. I am particularly interested in the comments that you made concerning leasing. There has been a lot of misinformation about it. The fact that your statement indicates an appreciation for and a retention of sensitivity to the needs of those industries, particularly those that are long-term capital intensive, and your recognition of the need to obviously accommodate some changes or modify those changes, I am sure, some to respond to real abuses. I just want to tell you I very much appreciate that because it is a good vehicle for increasing investment in capital plant and equipment, and it is a good vehicle for making sure we continue to employ our industrial workers which are vital to the Nation's security. And I am grateful to you for your recognition and inclusion of that issue.

Governor CAREY. Thank you, Mr. Bailey.

Mr. BAILEY. Thank you very much.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you very much, Governor.

Governor CAREY. Thank you, Mr. Chairman.

Mr. CONABLE. Welcome back. You are always welcome here whether you are still running or not, Governor Carey. We appreciate your——

Governor CAREY. You will always be my closet candidate for Governor, Barber. [Laughter.]

Mr. CONABLE. Just so I stay in the closet. [Laughter.]

Chairman ROSTENKOWSKI. The Chair calls Representative Tom Harkin.

Welcome to the committee, Tom.

You may proceed with your testimony. The committee is ready to receive it.

STATEMENT OF HON. TOM HARKIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. HARKIN. Thank you, Mr. Chairman.

I would like to ask that my entire statement be made a part of the record, and I will just comment on a few things in it.

The temptation is great to take a lot of your time and talk about the whole panoply of taxes and to tell you we just ought to junk the whole thing and start over. You do not have time for it. I do want to zero in on a couple of things.

First, the energy tax credits. I know you are covering that next Monday, Mr. Chairman. I could not be here next Monday, so I appreciate your kindness in letting me testify today.

Serving on both the Agriculture Committee and the Science and Technology Committee, I have had a first-hand look at some of these energy tax credits and how they have been used in the field. I believe they are an important element in our effort to commercialize alternative energy technologies and speed our efforts in energy conservation. When the administration testified before the Science and Technology Committee for this fiscal year's budget, they justified the proposed budget cuts in part by referring to the existence of the tax incentives as a helpful spur to assist industry in this area.

The resolution that I sponsored, House Resolution 243, which is the sense of the House-Congress resolution to keep these energy tax credits, now has the cosponsorship of 264 Members. I understand a similar resolution is in the Senate and has 63 cosponsors.

The amount of the taxes they are talking about recouping is very small. To repeal these energy tax credits they estimate they would get a one-tenth of a billion in fiscal year 1983, three-tenths of a billion in fiscal year 1984, and five-tenths of a billion for the following 3 fiscal years.

In fact, Arthur Little & Co. completed a study on the solar and wind credits, and they argued that one must take into account such factors as the increased taxes the Treasury will receive from the decrease in the tax-deductible business expense for conventional energy. If one does this, repealing the energy tax credits may actually cost the Treasury more money than it saves.

However, the most important point of the study, I think, was the argument that the credit substantially affects the amount of conventional fuel that industry uses to the extent that the credit is used. We will have less demand for imported oil with the credits and with less demand, a better balance of payments.

Since the mid-1970's we have developed small but growing renewable energy industries. These industries are fragile and weak, and they need nurturing; but they can grow with help to really make a contribution to the Nation's well being. I suggest that when we look at the help that almost every one of our competitors—Japan, Germany, Sweden, and so forth—are providing to their alternative energy and conservation firms, I think we ought to be doing more, rather than cutting back.

What we are running the risk of losing, Mr. Chairman, is the lead we now enjoy in certain areas like photovoltaics—turning sunlight into electricity. We could be handing future, very large multi-

billion dollar contracts to our trading partners. I do not think we ought to cut back on them. So I am hopeful, Mr. Chairman, you will not in any way cut back on the energy tax credit proposals that we have had enacted.

Mr. Chairman, I just want to take your time to talk about two new taxes that I hoped this committee would consider. Both of these are in areas of tax spending which I consider to be generally nonproductive: first of all the luxury tax, and a merger tax.

We had, as you know, an old excise tax that was imposed during World War II. It existed until about 1965, and then it was taken off during the Johnson administration. A luxury tax, however, would be different than that. You would not tax all washing machines and other goods like that. You would really target it to things like expensive watches, jewelry, cars, clothing, boats, airline tickets and things like that.

I have a sheet attached to the back of my testimony which indicates how it would be done. You set a 15-percent luxury tax. For example, on a watch, you set a base price of $100 or less—no taxes would be paid. Any watch over $100, the 15-percent luxury tax would apply. You take an automobile. An automobile under $15,000 would have no tax on anything over $15,000, a 15-percent luxury tax would be paid. You take a boat; $4,000 or under, no luxury tax would be paid. Over $4,000, a straight 15-percent tax would be assessed. For airline tickets, 15 percent of the ticket price above the regular coach fare would be subject to a luxury tax.

For example, Mr. Chairman, on pages 2 and 3 of last Sunday's New York Times there were ads for wristwatches costing $3,450, $2,450, and $1,995. As far as I am concerned, those folks can afford to pay a little bit of luxury tax on those items.

Now will this bring in a lot of revenue? No, it will not bring in a lot. We estimate, perhaps as much as $2 billion a year and that is a lot more revenue coming in than the losses we have in the energy tax credits. Two billion dollars a year from a luxury tax like this is not substantial, but it is something. Plus, it says something about fairness and equity. It is a little thing that we can do to tell the wage earners that there is going to be some more equity.

Last, I have a bill, H.R. 5719, which would place a 15-percent tax on all mergers of companies having more than $300 million in sales acquired by firms with more than $2 billion in sales. Again, a straight line 15-percent tax.

I believe these mergers tend to create a lessening of competition. I believe they increase inefficiency, and more importantly than anything else, they use up capital which causes an increase in interest rates. Preliminary estimates we have on a merger tax of this sort could be somewhere in the neighborhood of $4 to $5 billion a year, if you assume that there are somewhere between 20 and 80 mergers of this sort every year; that is, of a company of $300 million in sales or more being taken over by a company with sales of more than $2 billion a year.

Again, they are both things, I believe, that talk about equity: a luxury tax and a merger tax. A merger tax, equity in terms of our small businesses; a luxury tax in terms of our small taxpayers who are not going out and buying a $3,000 wristwatch. I just hope you will take a look at that, Mr. Chairman.

Thank you.
[The prepared statement follows:]

STATEMENT OF HON. TOM HARKIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. Chairman: I thank the Committee for this opportunity to discuss the need to maintain our renewable energy and conservation tax incentives.

When the President addressed Congress last September, he indicated that he was considering a proposal to repeal the tax incentives for Conservation and Renewable Energy as part of a package of "revenue enhancements".

I believe that those credits are an important element in our effort to commercialize alternative energy technologies and speed our efforts in energy conservation. When the Administration testified before the Science and Technology Committee for this fiscal year's budget, they justified the proposed budget cuts in part by referring to the existence of the tax incentives as a helpful spur to assist industry in this area.

On October 7, I introduced H. Res. 243 which simply said: "That it is the sense of the House of Representatives that the provisions of the Internal Revenue Code of 1954 which provide for energy conservation and development of renewable energy sources should not be repealed or amended to reduce such incentives."

That resolution has the co-sponsorship of 264 members of the House. A similar measure sponsored by Senators Chafee and Matsunaga is sponsored by 63 Senators. When the six month continuing resolution passed the Congress, it had a provision requesting that the President not propose the repeal of these provisions. Both the Committee and the substitute resolutions contained that language.

Unfortunately, the President has recommended repeal of some of those incentives. He did not propose repeal for the credits available to individuals. However, he does want to see the repeal of the credits for industry. These include the 15 percent credit for solar, wind, geothermal, and ocean thermal investment; the 11 percent credit for small scale hydroelectric projects; the 10 percent credit for intercity buses and biomass; and the exemption for alcohol fuels.

The amount of taxes involved is relatively small. The Administration predicts the Treasury gain from the repeal of these credits is $0.1 billion in fiscal year 1983, $0.3 billion in fiscal year 1984 and $0.5 billion for the following three fiscal years. Even those figures are subject to considerable doubt. Arthur D. Little and Co. completed a study last November on the solar and wind credits. That study argues that one must take into account such factors as the increased taxes the Treasury will receive from the decrease in the tax deductable business expense for conventional energy. If one does, repealing the energy tax credits may actually cost the Treasury money. However, the most important point the study made, in my opinion, was the argument that the credit substantially affects the amount of conventional fuel that industry uses to the extent that the credit is used. We will have less demand for imported oil with the credits—less dependence and a better balance of payments.

When we look at the economic problems facing the United States and our recent history, no one can ignore the tremendous effect of energy price and availability on the economy. Everyone remembers the awful 13.3 percent inflation rate we had in 1979. But, we must remember that the fuel componant of the Consumer Price Index went up 37.4 percent! Over 90 percent of the increase in the Consumer Price Index in 1979 over the previous year was caused by higher energy costs, costs directly traceable to OPEC.

We all remember the long lines at the gas pumps. We all remember the fears of the manufacturers and farmers in our districts over the danger of not having their energy needs met. Now we are seeing a real decline in petroleum prices over the last few months. I am glad to see prices fall. But, I remember the same feeling overtaking everyone after the oil price rise in 1974. We must remember the words of Sheik Yamani, the oil Minister of Saudi Arabia:

"Saudi Arabia's interest may appear to be served by lower production rates and higher prices, irrespective of the outcome. Let me remind you of my earlier statements regarding the link between price and consumption rates. Whenever prices go down, consumption goes up, and vice versa. Whenever oil prices increase, large amounts of capital are invested in search of alternative sources of energy and in a search for oil in different areas. If we force Western countries to invest heavily in finding alternative sources of energy, they will. This would take no more than seven to ten years and would result in reducing dependence on oil as a source of energy to a point which will jeopardize Saudi Arabia's interests."

We are sharply cutting back on government research and development. With the immediate decline in energy prices, many firms are or will soon be reevaluating their energy programs. We must not consider this an area purely for the neutral hand of the market. Energy is too easily manipulated.

Since the mid 70's we have developed small but growing renewable energy industries. These industries are fledglings. They are fragile and weak. They need nurturing. But they can grow with help to really make a contribution to the nation's well being. I suggest that when we look at the help that almost everyone of our competitors—Japan, Germany, Sweden, Britain and France are providing to their alternative energy and conservation firms, it might behoove us to do far more, not cut back. We are running the risk of losing the lead we now enjoy in certain areas like photovoltaics—turning sunlight into electricity. We could be handing future, very large multibillion dollar markets to our trading partners.

In addition, the cost of producing electricity is skyrocketing. Every new electric plant built—whether it is a nuclear plant or a coal plant—will create higher electricity costs. Through conservation, we reduce our need for new plants and thus help keep our costs down.

The tax credits provide a financial "risk premium" levied by the investment community when making investments in "first of a kind" projects or relatively new innovations.

In my work with the Science & Technology Committee I have become familiar with a number of firms which have sprung up. They are now just reaching a point where they are approaching a take off stage. An example of this comes from one company that I am familiar with—the Accurex Solar Corp. It was formed in 1980 as a joint venture between Accurex, a participant in DOE solar programs and Phillips Petroleum Co. I am pleased to state that the fruits of this venture are about to become evident. They are now in the latter stages of negotiation on several projects which will attest to the fact that the Federal R&D program for the parabolic trough solar system can be viewed as a success and will be commercially marketable. This firm's success with $150 million in projects would probably not have taken place were it not for the business tax credits.

I believe that the Ways & Means Committee should not reduce or terminate the energy tax incentives. I also believe that the 10 percent investment tax credit which expires at the end of this year should be extended. I do feel that we are in a terrible spot with a huge budget deficit on the horizon. However, there are other areas where increased revenue can be found. I feel a responsibility to make a couple of suggestions.

I would like to suggest two new taxes. Both tax spending which is generally nonproductive. Thus, the taxes would tend to shift spending to more productive investments. First, a luxury tax. I have attached a page to my testimony explaining such a tax.

The luxury tax is designed to tax real luxuries which are not usually purchased by most taxpayers. Watches, jewelry, cars, clothing, boats, airline tickets are all taxed. However, only the items in each category that are really luxury items are selected for tax. This is accomplished by placing a 15 percent tax for each item whose sales price is over a set threshold. For instance, everyone needs a watch. A watch need not be a luxury. My proposal would place a 15 percent tax on the portion of the watch's cost above $100. A $100 watch would not be taxed. A $1,000 watch would have a $135 tax. On pages 2 & 3 of last Sunday's New York Times were ads for watches costing $3,450, $2,450 and $1,995. Those folks can afford to pay the tax.

The second proposal is my bill H.R. 5719. It would tax those mergers by firms with more than $300 million in sales bought by firms with more than $2 billion in sales. These are usually non productive. They shift capital away from productive investment. The tax would reduce the mergers and in a sense pay the government back some of the money that it has provided through tax expenditures. Those tax expenditures were provided to promote investment. When productive investment does not occur, we should be getting some money back. Needless to say, exceptions from the tax are provided when the acquired company is in severe financial problems or when the merger will help our ability to compete in the world markets.

Through these taxes, we would generate some revenue from those most able to pay, and promote productive investments. Thank you.

LUXURY TAX

Item	Tax owed	Paid by	When paid	Comments
Jewelry, watches	15 percent of the retail price above $100.	Retailer	Within 60 days of the retail sale.	Including gemstones in consumer hands.
Clothing	15 percent of the retail price above $150.	do	do	
Automobile	15 percent of the retail price above $15,000.	do	do	
Boats	15 percent of the retail price above $4,000.	do	do	Including all extras added by the dealer within 30 days. Excluding commercial boats.
Airline tickets	15 percent of the ticket price above the regular coach fare.	Airline	Within 30 days after the flight.	
Hotel rooms	15 percent of the room price above $100.	Hotel	Within 60 days after the room is used.	Sleeping accommodations only.
Meals	15 percent of the price of a meal above $40 per person.	Restaurant	Within 60 days after the meal.	Liquor included. Cost of the table may be averaged.

Chairman ROSTENKOWSKI. Thank you very much.

Are there any questions of Representative Harkin?

Mr. Bailey will inquire.

Mr. BAILEY. One very quick comment.

I want to thank the gentleman for testifying. I want to tell you that I agree implicitly with your views on the business energy tax credits. I think you are 1,000-percent right, the changes would be counterproductive. I do not know about the other proposals. I will be very happy to take a look at them, but again I appreciate your raising the issue. It does not make good economic sense to make those changes. I think you are right.

Mr. HARKIN. Thank you. I hope you do take a look at that luxury tax.

Chairman ROSTENKOWSKI. Thank you very much for joining us.

The Chair calls Representative Dorgan.

Welcome to the committee, Byron. It is always nice to have you with us. You may proceed with your testimony. The committee is ready to receive it.

STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. DORGAN. Thank you, Mr. Chairman, members of the committee.

I would like to request that my full statement be included in the record.

Chairman ROSTENKOWSKI. Without objection, your full statement will be included.

Mr. DORGAN. Mr. Chairman, I will be brief.

My interest in discussing today with you the revenue-raising proposals and the attendant issues that have been discussed by Members of Congress and members of the administration is to ask some basic questions about their policy and direction.

One of the proposals that has been discussed is a minimum tax on corporations. Certainly I support that, but it is important to say that the reason a minimum tax is even being discussed is because

the entire tax system has failed. If the tax system worked the way it ought to work in this country, we would not need "minimum taxes." What we are going to ask corporations to do, is to go through the entire drill, to employ lots of accountants and attorneys, and finally conclude they do not owe a tax, and then add on a minimum tax after they have gone through that entire exercise.

These kinds of things are symptoms of failures in the system. I know many members of this committee feel that if we could back away from that system just a little bit, we would probably see that the best approach might be to restructure the whole thing. The more we try to loophole our way to economic well-being, the less results we are going to have.

American industry is competing with the Japanese—others who seem to be investing in the marketplace, in new plants and equipment. Meanwhile, our American businesses are trying more and more to find their net profit by investing in tax lobbyists and accountants and attorneys. That is a nonproductive investment.

We have built, through our tax laws, an entire paperwork industry. I think this is an appropriate time for us to ask why, and what should we do about it.

The question now is: What do we do about the revenue hemorrhage that we have created?

We have some folks telling us that the first thing to do obviously is to delay the tax cut that we have given to the working folks in this country. I think we need better priorities than that.

One of the first priorities ought to be to take a look at the very expensive ornaments that were added to the tax bill last year, most of which benefited the larger enterprises in the country.

My feeling is that instead of looking first to the individual tax cut, we ought to look last to the individual tax cut when we are trying to figure out where we can get some additional revenue. Certainly we might have to take a look at that individual tax cut in the end. But first we ought to go through the list of loopholes we have put into the law not only in this past session of Congress but in many previous sessions of Congress. We should look at the loopholes that, No. 1, are inefficient; No. 2, do not work; and, No. 3, as I said before, cause tremendous hemorrhage in our revenue system.

I think that most members of this committee would conclude that the administration's proposals, first, are not adequate. They do not meet the problem. We have got to try and find more money than they are suggesting in order to balance the budget. No. 2, the administration looks in the wrong places in many instances.

I simply want to provide as much encouragement to this committee as I can to take a fresh look at the tax system Congress has created. Back off a bit. Take a look at all these preferences, exclusions, deductions, and the like that we have put into the system that represent backdown expenditures, and see if we cannot get some additional money that way.

Everybody in this country, individuals and corporations, because corporations are persons by law, everyone has a responsibility to help pay the bill.

When we put these preferences and exclusions and deductions into the law, we back some of these institutions away from helping to pay. When they do not pick up the tab, the working folks do.

The only part of the tax package that was passed last year that did anything for the working folks was the individual tax cut and we should try to preserve as much of that cut as we can.

Last night at the press conference the President, on network television, said something that was very interesting. He said the working folks in this country did not really get much of a tax break because, he said, the social security tax increases take most of it away.

It is interesting that on the one hand the President is suggesting that the tax break given the working people last year is going to unleash a spurt of activity and represents the engine that is going to bring this economy back to health. At the same time, he is suggesting that there was not much of a tax break anyway.

That is clearly a contradiction in the President's economic program, and it is a contradiction that we are going to have to deal with because he will not.

In sum, I am just asking this committee to take a new look at the efficiency and the inefficiency of most of the things that were included in last year's tax bill and use that approach to stop the hemorrhaging of the revenue system that has been so bad in the last 12 months.

Thank you, Mr. Chairman, for the opportunity to appear here this morning. I do have a written statement that goes into greater detail, and I have decided to submit that for the record.

[The prepared statement and attachment follow:]

STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. Chairman, Members of the Committee:

We in Congress are not the only group in Washington that is thinking about possible changes in the nation's tax laws.

Many of our big business leaders are doing the same thing.

They are calling for cuts in last year's tax cuts. Not their own tax cuts, of course. No, these leaders want us to cut back the tax cuts we enacted for individual American men and women and for our smaller businesses.

It's everyone else's tax cuts that they want us to cut first.

Keeping Their Billions

According to a recent study, in 1980 the Exxon Corporation paid 1.3% of its income in federal income taxes, while the average working person paid 10%. Now Exxon and its cohorts tell us that working and small business people should give up their pennies while they and their executives keep their billions.

We should reject that suggestion. It isn't wise. It isn't fair. And it is abominable economics.

Yes, we may ultimately have to make some adjustments in those individual tax cuts. But that should be our last resort, not our first.

Small as they were, and as tilted as they were to the very wealthy, those individual tax cuts were about the only thing that middle income Americans really got from the Administration's economic program. They need those tax cuts and they should be able to keep them.

If we were to totally eliminate the third year of individual tax cuts, as some have suggested, we'd be depriving middle income people of about one-third of the tax cuts we enacted for them last year. Meanwhile, people making $200,000/year and over -- a group which includes many top corporate executives themselves -- would lose only 10% of their tax cuts.

Upside Down Analysis

The big business leaders have it upside down. It's their loopholes, not the across-the-board cuts for other Americans, to which Congress should look first. And this doesn't just include the trough at which the special interests fed so voraciously last year, to use Mr. Stockman's metaphor. It includes the whole array of loopholes -- now politely called "incentives" -- which are wreaking havoc with our economy and that have made our tax system a disgrace to our ideals of justice and fair dealing.

The case for putting these loopholes -- old and new -- first in line for cuts is compelling.

I. Most Big Business Loopholes are an Enormous Waste

Just one year ago the big business leaders were assuring us that new depreciation bonuses for them would unleash a flood of new investment that would raise our national economic waters and "lift all boats."

Now, a year later, the Commerce Department tells us that capital investment probably will fall this year, rather than rise.

Congress did its part. We gave all they asked for, and more. But they aren't coming through.

What are our major corporations doing with their new billions? They are shuffling paper.

Mergers, for example, have reached an all time high. When DuPont and Mobil engaged in their bidding war for Conoco, -- to take just one example -- it added nothing productive to our economy. It created not a single new job, except for the lawyers who grow rich arranging such deals. It created not an iota of new wealth.

Rather, such mergers and acquisitions merely clothe existing wealth in new forms and legal arrangements.

The wave of mergers which last year's tax bill encouraged is making our economy weaker, not stronger. It is diminishing competition, and that means less innovation and higher prices. It is also crushing the genuine producers in our private sector under more and more layers of management bureaucracy and conglomerate red tape.

In addition, last year's tax bill has diverted large amounts of corporate energy and resources into the buying and selling of tax breaks under the so-called "leasing" provisions of the tax bill. More paper shuffling. More concoction of income, without creation of underlying wealth.

Corporate paper shuffling induced by tax loopholes has become a massive drain in our economy. While the Japanese turn out engineers who design and build better products, we turn out lawyers, accountants, and MBA's who engage in sophisticated paper chases like these.

Their system rewards corporate investment in the market place. Increasingly, our's rewards corporate investment in politics.

Our tax laws have played a major role in turning our economy down this path of paper. It's time for fundamental change and a good place to start would be in many of the provisions of last year's tax bill.

2. Tax Loopholes are a Massive Government Interference in the Free Capital Marketplace

The Administration has told us time and time again that its economic program is intended to get government out of the free market place.

The new depreciation and sell-your-tax-break provisions do the opposite. They use government to rig the capital marketplace.

They make the tax laws themselves a major factor in investment decisions. They turn good investments into bad investments and bad investments into good investments. Even the Economic Report of the President this year acknowledged how such depreciation and other provisions distort the use of capital in our economy.

We are using capital much less productively than we should, and tax provisions like the ones we enacted last year are part of the reason.

It is curious to hear ardent defenders of the "free market" rush to the defense of subsidies like the sell-your-tax-breaks provisions which make hash of the free marketplace and which undermine the very premise that this marketplace, and not the federal government, should determine who succeeds and who doesn't.

3. Tax Loopholes Don't Address Today's Economic Problems

Taxes are not the major problem facing American Business today.

Our steel mills and auto plants are not shutting down because of taxes. They are shutting down because of high interest rates and a lack of demand for their products. Many such companies would be delighted to pay a little tax, if it meant they had profits to pay them from.

Depreciation allowances and other gimmicks don't do a bit of good for a company that can't afford to borrow the money it needs to buy a machine in the first place. Until we understand that, we aren't going to make any progress out of this economic morass.

That's why cutting interest rates has to be our economic priority number one. And that is why we must take a good sharp knife to wasteful loopholes. They are increasing the federal deficit and putting upward pressure on interest rates.

That makes our economy worse, not better.

4. Corporate Tax Breaks Were Not Even Part of the Original Supply Side Program

The enormous new corporate tax loopholes Congress enacted last year were never part of the genuine supply side agenda. You will not find them in the original Kemp-Roth package. They only have the most tenuous connection to the supply side thinking on which that package was based.

The corporate depreciation provisions and others were tacked onto the Administration program as a political sop to big business, to get them "on board." That's all there was to it.

And that's where the "bidding war" really began.

Supply side thinking is based on individual incentives, on the notion that people work harder and more productively when -- and only when -- they get a greater monetary return. That's a suspect notion. You don't have to be a psychologist to know that people do what they do for a wide variety of reasons, of which monetary rewards are just one.

Nevertheless, the corporate bonuses we enacted last year have nothing to do with that kind of supply side thinking. They have nothing to do with individual incentives. To the contrary, they simply increase the capital and power flowing to the very largest corporations, as opposed to the smaller businesses and individual entrepreneurs with which these corporations compete for capital and resources.

I'm not saying that the supply side view is adequate as a description of human nature or as a prescription for economic well being. But if the largest corporations of this country want a supply side program, then they should be first to rise in defense of the individual tax cuts.

5. We Cannot Loophole Our Way to Economic Well Being

Congress has become obsessed with the notion that for every problem in our nation, there is a new tax loophole that will solve it.

Actually, this notion has been cultivated by lobbyists who cannot peddle their wares in any other package.

The results of last year's tax bill should begin to teach us that loopholes are not a solution to economic problems.

Tax loopholes are like dollars. The more you create, the less value any of them have. Today we have such a crazy quilt of conflicting loopholes that virtually none of them achieve the results claimed. All they produce is massive confusion.

They are also leading our economy down wasteful and destructive paths, of which the paperwork blizzard is just the beginning.

Enormous tax breaks for the oil industry, for example, have kept alternative energy sources like solar and gasohol off the market. This, in turn, has kept us dependent upon the Arab oil shieks.

Similarly, large corporations are buying up thousands of acres of American farmland, threatening our family farms and our rural communities, largely due to the tax provisions that reward this behavior.

In these and a multitude of other ways, tax "incentives" have made our economy not better, but worse.

A Different Approach

A year ago, I proposed a completely different approach to business tax cuts.

I proposed that since small businesses account for a full 48% of the private sector gross national product, they should get 48% of any business tax cuts we enacted last year.

Small businesses are the prolific source of new jobs and innovation in our economy. It made sense -- and still makes sense -- to tilt the business tax cuts in this direction. It makes sense to put our money on tomorrow rather than on yesterday.

Yet, in last year's tax bill, we simply transplanted billions of dollars worth of fat and waste from government bureaucracies to the bureaucracies of some of our largest corporations. Now we are seeing the results -- or lack of results.

We should totally reverse that approach.

An easy first step would be to cap the depreciation breaks -- to limit the amount that would be available to any one firm.

This would target the benefits to the smaller firms. It would give us the most bang for our bucks in terms of new jobs and productivity.

It would staunch the hemorrhage of revenue that is resulting from those depreciation provisions. So doing, it would help reduce the deficit and get interest rates down.

We could apply this same capping approach to other provisions in last year's bill.

We shouldn't stop there. There are billions of dollars worth of additional loopholes that we should close. First on the list should be provisions which encourage mergers and thus promote monopoly, bureaucracy, and waste in private business.

Goal: A Simpler System

Our ultimate goal should be a tax system that is fair and simple and that everyone understands. The complexity of our tax laws is the number one intrusion of government into the private lives of our citizens, and it is the number one monkey wrench in the workings of our economy.

We have turned what should be a simple civic duty -- paying taxes -- into an annual nightmare. And we have turned what should be a system for raising revenue into a vehicle for attempting to alter the

economic behavior of the American people. The system has become so complex, so fraught with conflicting and wrong-headed "incentives," such a gold mine for parasitic paper shuffling, that it is heading for a massive siezure.

We simply have to turn this system around. An assault on the loopholes enjoyed by our largest corporations would be an excellent place to start.

Cleveland Plain Dealer Sunday, April 11, 1982

Let's end tax loopholes

By Rep. Byron Dorgan

PACIFIC NEWS SERVICE

WASHINGTON

There has been a lot of talk lately about the way the federal government intrudes into our lives. Federal income taxes probably are the biggest intrusion of all.

It's not just the amount of taxes that we have to pay. That's just half the problem. The other — and probably greater — half is the staggering complexity of income tax laws. They intrude into virtually every nook and cranny of our lives and turn all of us into bookkeepers and accountants for the federal government.

This becomes painfully clear at this time of year as we rummage frantically through pants pockets and drawers for old check stubs and receipts and as we tear our hair trying to figure out the difference between a capital asset and a loss carry-over.

At last count, we spent nearly 200 million hours each year laboring over individual tax returns, and many, many more on keeping the records for these.

We pay professional tax preparers such as H & R Block roughly $1 billion to help us with this chore, and we spend another $1 billion on the IRS bureaucracy

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that is necessary to oversee this exhaustive paper chase.

On top of this is the monumental cost to business of the army of lawyers, accountants and clerks in the mountain of paper work necessary to comply with — or get around — the federal income tax laws.

In short we have turned what should be a simple civic duty into a public works project of lawyers and accountants, and an annual nightmare for the rest of us.

Tax loopholes, the source of all this complexity, now cost more than $300 billion a year. That's more than welfare, period. More than defense, period. Loopholes are the part of the federal budget that is growing most rapidly.

Are they worth it? Is there any reason for all the headache and harassment when we could have a system that is much simpler?

One myth is that tax loopholes "stimulate the economy" or perform some other office of virtue. In fact, layer upon layer of loopholes have done just the opposite. They have

COMMENTARY

become a burden on the economy. They have diverted the energy and resources of our business people away from productive investment into tax avoidance that has our economy tied up in knots.

Instead of looking to the marketplace for their profit, our business leaders look increasingly to the tax laws.

Take the wave of corporate mergers that is sweeping over our economy. These mergers are eliminating competition and are ensnaring genuine producers in our economy in conglomerate red tape.

The hidden engine behind these mergers is the phalanx of tax loopholes that reward this behavior.

When U.S. Steel Corp. bought Marathon Oil a few months ago, it wasn't just itching to run an oil company. Instead, U.S. Steel executives had their eyes on the $1 billion in tax breaks that they could gain from this deal.

Such mergers add nothing to our economy — no new jobs, no new wealth. All they do is clothe existing wealth in new and more expensive legal forms — with corresponding employment opportunities for the attorneys and financiers involved.

Another example of tax-loophole-induced paper shuffling is the scandalous provisions in last year's tax-cut bill that enabled large corporations to buy and sell their tax breaks to each other. This single provision overnight created a $100-million make-work industry for lawyers and investment brokers, some of whom labored behind the scenes to gain enactment of the provision in the first place.

Tax provisions like these have helped attorneys and accountants shove aside production managers as the helmsmen of American business. The Henry Fords and the Thomas Edisons — people who knew products — have been replaced in our corporations by people who play games with numbers and concoct income out of tax loopholes and other paper-shuffling hocus pocus.

Despite all this, Congress continues to be obsessed with the notion that for every problem in our nation there is a new tax loophole that can solve it. This was the excuse for the plague of new loopholes that found its way into last year's tax-cut bill.

Does this mean that tax cuts are wrong? Absolutely not. We just need to change the way we cut taxes.

Instead of adding more and more loopholes, we should chop the tax rates way down and eliminate the need for all the complexities that are driving everybody crazy.

Working and small-business people would be much better off with a drastically simpler system than what we have today, one which enables most people to pay less by making sure that everyone pays their share.

We have to start talking about a tax system that has a minimum of deductions and other complexities and very low rates. Instead of making people run a confusing gauntlet of deductions to whittle down their tax to a reasonable level, why not let people pay a reasonable tax rate in the first place and do away with all the song and dance?

I think we could have a simple one-page tax form that most of us could fill out in half an hour.

Dorgan, D-N.D., serves on the tax subcommittee of the House Small Business Committee.

PACIFIC NEWS SERVICE

Chairman ROSTENKOWSKI. Thank you, Byron, for joining us this morning.

Are there any questions of Mr. Dorgan?

Mr. Conable will inquire.

Mr. CONABLE. Mr. Dorgan, you are not suggesting that we chuck the tax cuts because they are not big enough, are you?

Mr. DORGAN. I do not think I said that.

Mr. CONABLE. No, I mean you were saying the President was to be criticized because he said there was no real tax cut involved anyway.

Mr. DORGAN. First of all, understand I am not suggesting you chuck the tax cuts for the working folks in this country. Many people in this town counsel that we ought to get rid of that tax cut first. But, to the contrary, that ought to be the last thing we get rid of because that is the only thing the working folks got last year.

All I was saying is that last evening the President said on the one hand that these massive tax cuts given to the middle-income Americans represent the engine that is going to drive this economy toward future abundance. On the other hand he was saying these tax cuts given the working folks were really not tax cuts at all because they were absorbed by social security increases. He was using those same tax cuts for the purposes of two conflicting arguments.

Mr. CONABLE. Is it not possible that if we did not have those tax cuts the drag on the economy would be very severe?

Mr. DORGAN. We are not arguing. We agree on those cuts. But I am simply saying that this is the first tax cut that the big business lobbyists in this town want us to eliminate. I am saying it ought to be the last, because I think if you look at the efficiency of public spending——

Mr. CONABLE. I think we agree on that. Very good.

Mr. DORGAN. The rest of the answer would have been good, Congressman Conable.

Mr. DUNCAN. Did you vote for the Democratic alternative tax cut?

Mr. DORGAN. Pardon me?

Mr. DUNCAN. Did you vote for the tax cut bill last year?

Mr. DORGAN. I did.

Mr. DUNCAN. On final passage?

Mr. DORGAN. Yes.

Mr. DUNCAN. And do you think we should pay $100 billion in interest on our debts? Do you think we should pay that?

Mr. DORGAN. Of course.

Mr. DUNCAN. Do you not think it is related to the deficit we have?

Mr. DORGAN. What relates to the deficit?

Mr. DUNCAN. The $100 billion that we are having to pay on debt service because of debts that prior administrations, Republican and Democrat, have passed on to this President. Do you agree that the large debt service has something to do with the deficit?

Mr. DORGAN. Of course.

Mr. DUNCAN. Thank you.

Mr. DORGAN. And I think that the kind of tax cut we passed last year contributes to the largest deficit in the history of this country.

That is why we ought to stop the inefficient new loopholes that were included in that tax cut.

Mr. DUNCAN. Thank you.

Mr. MATSUI. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Brodhead will inquire.

Mr. BRODHEAD. Thank you, Mr. Chairman.

Let me just say, Mr. Dorgan, that as always you take a very thoughtful approach to these problems, and I am very much in agreement with the general thrust of what you are saying. And I hope that we can continue to work together to try to come out where you are, because as I see it, with the actions we have taken in the last several years with respect to the Tax Code, we have made it ever more complicated, ever more difficult, and we continually find ourselves dealing with proposals such as those that are being made currently by the adminstration that are an effort to undo the impact of things we have done before.

And I think you are exactly right that it is time to stand back a little and see if we cannot take a more fundamental approach to solving the problem rather than to continue to try to put patches on patches.

So I thank you for the assistance that you have provided to the committee in this regard.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman.

I, also, Mr. Dorgan, would like to commend you for your statement. I have not had the pleasure yet of reading your statement, but from what you have said so far I think you are right on point.

I would like to characterize your statement just so I have no misunderstanding of it. You are saying basically we have to come up with additional revenues. I think we all realize that. Instead of looking at the 10-percent cut due to come into effect in 1983, you are suggesting that we perhaps look at accelerated depreciation and those other cuts that we gave last year and prior years.

I think that is only sensible, and I think we have a responsibility to do that. Frankly, if we do do that, that might give a more equitable distribution of the tax cuts last year.

Mr. DORGAN. Well, I think that is exactly right. Our Tax Code is making good investments bad investments in some cases, and it is making bad investments good investments in other cases. Our Tax Code is not neutral from an economic standpoint. I think we should really take a look at the efficiencies of those kinds of preferences.

Mr. MATSUI. Thank you very much.

Chairman ROSTENKOWSKI. Are there any further questions?

[No response.]

Chairman ROSTENKOWSKI. Thank you very much, Byron, for joining us.

Mr. DORGAN. Thank you.

Chairman ROSTENKOWSKI. The Chair calls Mr. Brophy, Mr. Baldwin, Mr. O'Brien, and Mr. Stewart.

Welcome to the committee, gentlemen. It is always a pleasure to have you with us. Many of you have testified on several occasions before this committee.

If you would like to begin, Mr. Brophy, identify yourself for the record and proceed with your testimony. I will introduce each of you.

Mr. Brophy, you may proceed.

STATEMENT OF THEODORE F. BROPHY, COCHAIRMAN, BUSINESS ROUNDTABLE, CHAIRMAN OF THE TAXATION TASK FORCE, AND CHAIRMAN OF THE BOARD, GENERAL TELEPHONE & ELECTRONICS CORP.

Mr. BROPHY. Thank you very much, Mr. Chairman, and distinguished members of the committee.

My name is Theodore F. Brophy, I am chairman and chief executive officer of GTE. I also serve as cochairman of the Business Roundtable, and chairman of its taxation task force.

I appreciate the opportunity of appearing before you today on behalf of the Business Roundtable. I would like to request at this time that my written statement be accepted for the record.

Chairman ROSTENKOWSKI. Your entire statement, Mr. Brophy, will be included in the record. The statements of all the witnesses will be included in the record.

Mr. BROPHY. Thank you very much, Mr. Chairman.

Last year we saw a major change in the direction of economic policy designed to reduce the growth of Government spending and taxes, while at the same time moderating the growth in the money supplies. The purpose was to increase savings, investment, and productivity, to reduce inflation, and lay the base for a long resurgence of real economic growth.

The Roundtable strongly supported the basic principles and objectives of the economic program, and continues to believe that the program's direction is sound and should be pursued.

At this time, through a combination of circumstances, we are faced with a recession, inordinately high interest rates, and the prospect of continuing substantial deficits. Neither monetary nor fiscal policy can assume full responsibility for solving these problems. It is clear that a predictable monetary policy is necessary to calm the volatile financial markets.

At the same time, there is a strong general perception that large projected deficits create the possibility of continued high interest rates. Unless dealt with promptly, that expectation will delay reasonable recovery from the current economic recession, and may exacerbate the situation.

For this reason, the Roundtable is deeply concerned about the size of the projected budget deficits. The need for action is clear and urgent. A stalemate on the budget with its adverse implications for interest rates, financial markets, unemployment, and the general economy is not an acceptable alternative.

This committee and the Congress, working on a bipartisan basis with the President, must seize the opportunity to change the direction of projected deficits and put them squarely and decisively on a downward path without altering the basic thrust of our current economic strategy.

Adjustment to a fiscal policy framework that will assure a lowered projected deficit should enable the Federal Reserve to stay

with its anti-inflationary policy without being excessively restrictive. This would permit a lasting decline in interest rates.

The seriousness of the deficit situation requires that budget projections include more substantial spending cuts. Such cuts can only be achieved by scrutinizing every agency, department, and area of the Federal Government, including entitlements and defense.

The deficit problem cannot be adequately addressed without a permanent modification in the method of indexing entitlement benefits to reduce their growth rate. We fully support a strong defense posture, believing that it is critical to our national security and stability of the world.

A strong economy in future years will also be helpful for the protection of our Nation. We believe that defense spending should be re-examined on its merits, and directly in relation to its contribution to military capability and the Soviet threat to insure that these spending levels are essential. Every effort must be made to generate additional savings through improved planning and efficiency without impairing national security.

Assuming major spending cuts can be achieved, we believe it still may be necessary to adopt some revenue increases to assure a strong, credible downward trajectory in deficits. To the extent that revenue increases are required, we would prefer to see these in the consumption area. Increases in Federal excise taxes and user fees, and the deregulation of natural gas are options that would have the least disruptive impact on incentives to work, save, and invest, and future planning for individuals and business.

We would oppose any modification of the 10-percent July 1982 tax cut because of its equity, the expectation of the American people, and its critical impact on economic recovery. We would support a stretchout of the 10-percent July 1983 cut, but only as a final option if required by critical economic needs and only after the areas previously mentioned have been fully addressed.

Under the present circumstances, we believe that individuals will benefit more from lower deficits and interest rates than they would lose from a short delay or a minor modification in the implementation of the 1983 cut. We would not recommend changes in any other provisions of ERTA, with the exception of tightening of safe harbor leasing rules to eliminate any potential abuses.

The administration has proposed revisions, including a minimum tax, and improved collection and enforcement procedures in its budget. These proposals would reduce business benefits from ERTA by more than 40 percent for fiscal years 1983 through 1985. The business community certainly favors Government improvement of its tax collection procedures.

There is however strong opposition in the business community to the administration's proposed alternative minimum tax on corporations, which is widely viewed as an ill-advised attempt at substantive tax reform. This tax would fall unevenly across businesses, penalizing those that are most capital intensive, and would in some cases result in greater tax burdens than before ERTA.

Let me underscore our position: Additional spending cuts from all areas of Government must be the first line of defense for a sound budget. Any tax increases on individuals or business must be limited to major spending cuts as part of an overall program to

attack the projected budget deficits. If major spending cuts are not achieved, we would be unalterably opposed to increasing individual or business taxes as a mechanism of closing the deficit gap.

In summary, the Business Roundtable urges that a bipartisan plan be promptly implemented that will address the critical need to lower future deficits on a credible basis and insure sound economic recovery and long-term growth.

Thank you.

[The prepared statement follows:]

STATEMENT OF THEODORE F. BROPHY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GENERAL TELEPHONE AND ELECTRONICS CORP., ON BEHALF OF THE BUSINESS ROUNDTABLE

SUMMARY

This country has, over a period of years, developed a number of deep-seated structural economic problems. A major change in the direction of our economic policy was made in 1981 in order to increase savings, investment and productivity while reducing inflation. The Business Roundtable supported the basic principles and objectives of this economic program and continues to believe that its direction is sound and should be pursued.

At the same time, our economy is in the throes of a recession, accompanied by inordinately high interest rates, and now is facing the prospect of large future budget deficits. Neither monetary nor fiscal policy alone can assume full responsibilityfor solving these problems. The Roundtable is deeply concerned about the size of projected deficits and believes that, unless promptly dealt with, they will encourage continued high interest rates and slow economic recovery and growth.

Action is urgently needed on a bipartisan basis to change the direction of projected deficits and put them squarely and decisively on a downward path without altering the basic thrust of our current economic strategy. A stalemate on the budget, with its adverse implications for interest rates, financial markets, employment and the general economy, is not an acceptable alternative.

The seriousness of the deficit situation requires that future budgets include more substantial spending cuts, including a reduction in the projected rate of growth for entitlements and defense. In particular, the formula used for indexing many entitlement programs must be adjusted to a more realistic level on a permanent basis.

If revenue increases are still required to close the deficit gaps to reasonable levels, we would prefer to see them in the consumption area. Increases to federal excise taxes and user fees and the deregulation of natural gas would appear to be the most sensible methods of raising additional revenue. As a final option, and only if required to meet critical economic needs, we would recommend a stretch-out of the 10% July, 1983 individual tax cut.

We do not object to initiatives to improve tax collection and enforcement procedures proposed by the Administration, but do strongly oppose the alternative minimum tax as ill-advised substantive tax reform. This tax would fall unevenly across business, penalizing those most capital intensive and would, in some cases, result in a greater tax burden than before ERTA.

The Roundtable urges that a bipartisan plan be promptly implemented that will address the critical need to produce lower future deficits on a credible basis and ensure sound economic recovery and long-range growth.

STATEMENT

Mr. Chairman, distinguished members of the Committee. My name is Theodore F. Brophy. I am chairman and Chief Executive Officer of General Telephone & Electronics Corporation. I serve as Co-Chairman of The Business Roundtable and Chairman of its Taxation Task Force. The Roundtable is an organization comprised of approximately two hundred chief executive officers from corporations that represent many billions of dollars of capital investment and provide millions of jobs for our nation's economy. I sincerely appreciate the opportunity to appear before you today on behalf of The Business Roundtable and to present the Roundtable's views concerning the Administration's budget proposals in general, with specific reference devoted to the tax aspects of such proposals.

This country has, for many years, been faced with the deep-seated structural problems of inflation, low productivity, low savings and capital formation and higher and higher effective tax rates providing a disincentive to work and to the private initiatives on which this country was built. Last year we saw a major change in the direction of economic policy designed to reduce the growth of government spending and taxes while, at the same time, moderating the growth in money supply. The purpose was to increase savings, investment and productivity, to reduce inflation and lay the base for a long-term resurgence of real economic growth. The Roundtable supported the basic principles and objectives of this economic program and continues to believe that its direction is sound and should be pursued. As this program moves forward, however, economic conditions may dictate that adjustments be made to the plan in order to keep it on course.

We are currently faced with difficult economic times. Through a combination

of circumstances, a severe recession is in progress and at the same time, we are experiencing inordinately high interest rates. Budget projections, a detailed analysis of which is attached as Exhibit I, have been released that hold out the prospect of continuing large deficits and substantial future government borrowings to fund such deficits. As Exhibit II indicates, most private economic forecasters are projecting even higher deficit figures than the Administration. In addition, on March 24, 1982 Treasury Secretary Donald T. Regan indicated that as a result of the sharpness and depth of the current recession, the Administration's projected budget deficit figures for Fiscal Year 1983 and beyond would have to be revised upward

There is a growing perception in the business community that large projected budget deficits for Fiscal Years 1983, 1984 and 1985 create the possibility of continued high interest rates. That expectation will delay reasonable recovery from the current economic recession, and unless dealt with promptly, will serve to exacerbate the current situation. Low economic growth increases government expenditures and decreases revenues, thereby widening budget deficits. For these reasons, The Business Roundtable is deeply concerned about the size of projected budget deficits and believes that a "mid-course correction," but not a change in policy direction, must be made in our current economic strategy to reduce these deficits.

The need for action is clear and urgent. A stalemate on the budget, and its implications for interest rates, financial markets and the general economy, is not an acceptable alternative. We must seize this opportunity to change the direction of projected deficits and put them squarely and decisively on a downward path without altering the basic thrust of our current economic

strategy. This result cannot be achieved without the guidance and support of both political parties in Congress. Statesmanship must be exercised on a bipartisan basis.

The Effect of Budget Deficits on Interest Rates

It has been suggested that large budget deficits do not have an adverse impact on interest rates. While this may have been true during most of the postwar period, the evidence since 1979 no longer appears to support this concept. A historical comparison of budget deficits and interest rates is shown in Exhibit III.

The chart was developed using "real" short-term interest rates, i.e., nominal rates adjusted for inflation, and by seasonally adjusting the surplus/deficit figures. When the data is presented in this way, a parallel pattern can be seen. But this pattern does not imply a direct cause and effect relationship.

At the onset of the recession, interest rates usually peak as businesses and households attempt to maintain their spending plans in the face of declining revenues. Then as the recession becomes more broadly established and economic activity declines, budget deficits rise and interest rates generally decline due to a slackening in loan demand. In the latter stages of recovery, interest rates again rise as loan demand increases and inflation accelerates.

The key point is that this pattern changed significantly after 1979. As can be seen in the chart, after 1979, the pattern shows a divergence with sharply higher real interest rates and a substantially larger deficit. While there is

no single factor that clearly explains the rise in real interest rates, it is generally agreed among businessmen and economists that this may be due to increased uncertainty regarding the future course of monetary policy, especially in view of the projected large budget deficits. Since 1979, the Federal Reserve has refused to monetize the deficit, and has placed new emphasis on controlling the money supply in an effort to reduce inflation. This change can be seen in the table in Exhibit IV. The table clearly shows that the degree to which the federal debt has been monetized has been greatly reduced since 1979. The large projected deficits have caused the financial markets to believe that this refusal to monetize will be only a temporary phenomenon and that at some point in the future the Fed will be forced to cave in and again monetize significant portions of the debt. This belief is keeping inflationary expectations alive and is contributing to higher interest rates.

The change in the Federal Reserve's policy was one of the important factors behind the recent improvement in inflation (Exhibit V). We have no choice but to provide a fiscal policy framework that will enable the Federal Reserve to stay with its anti-inflationary policy without being excessively restrictive. This would permit a lasting decline in interest rates.

Another change since 1979 is in the magnitude of the deficits. The current and projected deficits, as shown in Exhibit VI, are much larger, in absolute magnitude and relative to GNP, than during most of the postwar period. Moreover, for most of the period, the deficits were becoming larger only during periods of recession or mini-recession, whereas most current projections indicate that, unless significant action is taken, the deficit will be increasing at a time when the economy is expected to be in a recovery.

In order to finance large deficits during a period of recovery, the Treasury must either increase its borrowings from the public at a time when private demand for funds is also increasing, or the Federal Reserve must monetize a portion of the deficit, leading to a rekindling of inflationary expectations. Thus, rising deficits during a recovery will contribute to higher interest rates either because of an increased demand for funds or because of renewed inflationary expectations.

While it is true that a significant increase in personal savings rates could provide adequate funds to satisfy both private and public financing needs and still permit interest rates to drop substantially, the problem is that we are dealing with an equation that has many uncertainties. One of these uncertainties is the future rate of savings. If the savings rate in the future is high enough to accommodate these large projected budget deficits as well as growing private financing needs during an economic recovery, then the deficits would not have an adverse effect on the level of interest rates. There is always the possibility, however, that savings may not be adequate to finance both needed capital formation and growing deficits at the same time, in which case the large deficits will result in high interest rates or high inflation or both. Given the unknowns involved, we cannot do our planning on a best case approach.

In addressing these economic policies it is not possible to focus only on the tax and spending sides of this equation, so let me say a brief word about monetary policy.

Monetary Policy

A sound, consistent monetary policy is necessary for the success of the President's program. A plausible plan to reduce budget deficits in future years would relieve some of the pressure on the Federal Reserve. It would permit the Federal Reserve to pursue its policy of moderating the growth of money supply without causing undue increases in interest rates.

Large budget deficits threaten to undermine the Federal Reserve's anti-inflationary policy. This was clearly pointed out by the Council of Economic Advisers in the 1982 Economic Report of the President:

> "Theoretically, restrictive monetary policy could achieve price-level stability regardless of fiscal policy. As a practical matter, however, reducing the growth of government spending and reducing deficits in the Federal budget will help to strengthen the belief that anti-inflationary policies will be maintained. That, in turn, will help lower the costs of adjusting to lower rates of inflation. In short, the credibility of monetary policy is influenced by the fiscal policy that accompanies it."

In other words, large deficits make it difficult for the Federal Reserve to implement a credible anti-inflationary monetary policy. More importantly, prospects of persistent deficits, especially during a period of expected economic recovery, leads the financial community to expect that at some point in the future the Federal Reserve will be forced to monetize a portion of the debt. Thus, it is not only actual monetization of government debt, but also the increased likelihood of monetization in the future that promotes

inflationary expectations. This fear that the Federal Reserve may be forced to monetize a portion of the deficit in the future may be one of the reasons why interest rates have remained so high even during the present recession.

The United States has the highest level of "real" interest rates among industrial countries (Exhibit VII). Moreover, real interest rates are likely to remain high if investors believe that deficits of the current magnitude will persist for a long time. High real interest rates discourage capital investment and may be at least partially responsible for the current severe slump in the economy.

The Federal Reserve can also enhance its own credibility by achieving a more stable and gradual deceleration in money supply growth, which it was not able to achieve in 1981. As can be seen in Exhibit VIII, money supply growth continues to be highly erratic. It was well below the Federal Reserve's targets during most of last year, but ended the year with a rapid surge. Many analysts have advanced the argument that by being overly restrictive during much of 1981, the Federal Reserve inadvertently contributed to the current recession. As the recession deepened in the fall of 1981, the Federal Reserve permitted a surge in the money supply which was very evident in the early part of January, 1982. More recently, the money supply has again declined. By eliminating these gyrations -- either above or below the targets -- the Federal Reserve can reassure the financial markets, reduce the volatility of interest rates, and thus assist in promoting a more stable and sustained economic recovery.

The Need for Additional Spending Reductions

To the extent that the budget deficits can be closed through reductions on the expenditure side, this would be preferable for the long-term health of the economy. In this regard, no area of budget expenditures should be free from scrutiny, including defense and entitlements. We are not advocating a reduction in outlays for these programs, just slower rates of growth.

In particular, we cannot postpone any longer the difficult decision to bring the growth of entitlement programs under control and place them on a sound financial basis. Entitlements represent 47% of budgeted expenditures for 1983. They have been increasing in cost at a rate of about 15% a year -- far in excess of the general rate of growth of the economy. It is a matter of simple arithmetic that this condition cannot endure forever.

One of the major factors driving up expenditures for many of these programs is that they are 100% adjusted to the Consumer Price Index (CPI) by a process called "indexing." This is the case for social security and military and civil service pensions. We believe that the CPI, as currently constituted, frequently overstates the rate of inflation as it affects the consumer. For this reason, we support a thorough reexamination of indexing -- including the formula to be used, and the timing of forthcoming adjustments -- as a major part of an overall program to put our retirement systems and other entitlement programs on a sound financial basis. Slowing the rate of growth of these programs by changing the method of indexing and by delaying or freezing benefit levels for a time is critical to a credible attack on the deficits. This approach would not have an adverse effect on need or means-tested programs.

We recognize that there is a bipartisan commission currently studying social security and we certainly believe that this important effort should continue and will be of great benefit to the future health of the system. The commission will be reporting its findings and recommendations later this year. The indexing issue has already received widespread study, and it is critical that it be addressed immediately. The existence of the commission and its expectant report should not delay important decisions which should be made this spring.

We also recognize that some entitlement programs are considered to be untouchable in an election year. However, we were encouraged by recent reports in the New York Times that some groups representing the elderly are so concerned about projected budget deficits that they are becoming more receptive to some adjustments to these programs. This, we feel, is directly comparable to what is happening in many industries as workers are agreeing to deferrals of wage increases and COLA increases in order to keep their jobs in being.

We fully support a strong sustained defense posture, believing that it is critical for our national security and for the stability of the world. A strong economy in future years will also be helpful to the protection of our nation. Defense spending represents more than 25% of projected expenditures. We believe that defense spending should be reexamined -- on its merits, and directly in relation to its contribution to military capability and the Soviet threat -- to reaffirm that it is all essential and will be put in place at minimum cost. Every effort must be made to generate additional savings through improved planning and efficiency, without impairing national security.

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Revenue Increases

Assuming substantial spending reductions can be achieved, we recognize that it still may be necessary to adopt some revenue increases to assure a strong, credible, downward trajectory in deficits. We would like to make it clear that if major spending reductions are not made, we would be opposed to closing the deficit gap primarily through tax increases on individuals and business.

Our federal income tax system has, for many years, been directed toward increasing consumption and has acted as a disincentive to capital formation, personal savings and productive efforts. We supported action taken last year by this Congress and the Administration to change the direction of federal tax policy as essential for the long-term health of our economy. The Economic Recovery Tax Act of 1981 ("ERTA") has provided important tax relief for individuals and business, and if given a chance to succeed, will stimulate savings and investment. In the process, it will increase productivity, create more jobs and expand our tax base. To the extent that additional revenue increases are required, we would prefer to see them in the consumption area.

Increases in federal excise taxes and user fees and the deregulation of natural gas are methods for raising additional revenue that would appear to be the most sensible. Increasing the level of federal excise taxes could raise substantial revenue and would have the least disruptive impact on incentives to work, save and invest and future planning for individuals and businesses. The timing would seem ideal for gas deregulation beginning in 1983 because it would serve as a revenue producer and come at a time when energy costs are declining. In the long-run, this may hold energy costs down and decrease our

reliance on foreign energy sources. Gas deregulation would stimulate exploration efforts and promote conservation.

As a final option, and only if it is required to meet the critical economic need for a steady and significant reduction in projected deficits, we would recommend a stretchout of the 10% July, 1983 individual tax cut. It should be emphasized that we are opposed to any modification of the 10% July, 1982 tax cut because of the expectations of the American people, its equitable need to offset inflationary bracket creep and its critical impact on economic recovery. We are also not recommending an elimination of the 10% July, 1983 cut, but, only as a last resort, a stretchout of its implementation in order to reduce the deficit to acceptable levels and to permit a lower and more reasonable level of interest rates. Under present circumstances, we believe that individuals will benefit more from the stimulation of the economy that would result from lower interest rates than they would lose from a short delay or minor modification in the implementation of the 1983 cut.

We strongly believe that ERTA provided important incentives for increased capital formation that are essential for future economic growth. Changes in the tax law, however, cannot, by themselves, dictate investment decisions. A capital spending boom could not have been expected in the face of the current high levels of interest rates and the slowdown in our economy. Investment decisions are a function of profit opportunities, market forces and interest rates, as well as taxes. We would oppose changes to any other provisions of ERTA, with the exception of tightening of the safe harbor leasing rules to eliminate any potential for abuse.

The Administration has proposed tax revisions and improved collection and enforcement procedures that would raise about $12 billion in Fiscal Year 1983 and $35 billion in the succeeding two fiscal years. Most of these measures would apply to business and would reduce business' benefit from ERTA by more than 40% for Fiscal Years 1983-85. The business community does not object to the government's improvement of its tax collection procedures. There is, however, strong opposition in the business community to the Administration's proposed alternative minimum tax on corporations.

It should be noted for the record that business received a substantially smaller portion of the total tax reduction provided by ERTA than it received in other major tax reduction acts, such as the Revenue Acts of 1962, 1964 and 1978. We do not say this by way of complaint, because we supported ERTA, but we say this for the record because now is not the time to kill the goose that lays the golden eggs in the form of more jobs.

The proposal for an alternative minimum tax on corporations is widely viewed in the business community as an ill-advised attempt at substantive tax reform that is seriously flawed from both an economic and tax policy standpoint. Among the Roundtable's specific reasons for opposing this measure we would include the folowing:

- o The minimum tax will constrain corporate cash flow at a precarious time in cur financial history.
  - The New York Times reported on March 12, 1982 that current corporate liquidity is at its lowest point since World War II.

- o Its impact will fall unevenly throughout industries and taxpayers.
  - One company may have basically the same tax picture as a competitor in the same industry, except for the fact that it is engaged in a large capital expansion program, and as a result, is subject to the minimum tax while its competitor is not. The impact of the tax could be particularly onerous for a company trying to recover from a period of economic distress by accelerating its growth.

- o It is more sensible from a tax policy standpoint to adjust perceived abuses in the tax law directly rather than indirectly through a minimum tax.
  - If a particular provision is a problem or has outlived its usefulness, the minimum tax is an ineffective and incorrect way to cure the ailment.

- o The minimum tax could neutralize many of the benefits of ERTA.
  - Many companies in the steel industry estimate that they will have higher future federal tax bills as a result of the minimum tax than they would have experienced if ERTA had not been enacted.

- o The minimum tax reduces the value of the investment tax credit, and in effect, penalizes capital formation.
  - A recent survey indicated that more than 50% of the electric utilities would be adversely affected by the minimum tax constricting the utilization of their investment tax credits, particularly those with active expansion programs (creating jobs, etc.).

- o The minimum tax could lead to large future business tax increases.
  - Any item on the widely-disputed "tax expenditure" list could become a candidate for inclusion on the list of tax preferences.

- o The minimum tax will add tremendous complexity to the tax laws and a new degree of uncertainty to business planning.

The tragedy of the minimum tax is that recent financial statements, adjusted for inflation under the mandate of FASB Statement No. 33, indicate that many U.S. corporations have little or no real economic earnings, a problem which was partially addressed by ERTA.

In Conclusion

Clearly this is a time for a bipartisan effort of Congress and the President, working together, to produce a budget plan which will show to the American people that the federal government has control over its financial resources. The economy cannot accept a stalemate in the budget process. Time is of the essence; failure to act will delay the recovery and most likely increase the projected deficits.

ADMINISTRATION PROJECTIONS OF BUDGET DEFICIT

1. Budget Deficit Estimates - Fiscal Years; Dollar Amount in Billions

	1982	1983	1984	1985	1986	1987
Administration forecast	-98.6	-91.5	-82.9	-71.9	-66.0	-53.2
Alternative deficit projections						
Higher growth/lower inflation	-94.0	-74.7	-50.7	-23.9	-0.6	28.8
Lower growth/higher inflation	-102.8	-108.3	-115.1	-119.9	-131.4	-135.2

2. Economic Assumptions - Calendar Years; Percent Change:

	1982	1983	1984	1985	1986	1987
Real GNP growth rate:						
Administration forecast	3.0	5.2	4.9	4.6	4.3	4.3
Higher growth scenario	4.2	6.4	6.1	5.8	5.5	5.5
Lower growth scenario	1.8	4.0	3.7	3.4	3.1	3.1
Inflation (GNP deflator):						
Administration forecast	7.2	5.5	4.9	4.6	4.6	4.4
Higher growth scenario	6.0	4.3	3.7	3.4	3.4	3.2
Lower growth scenario	8.4	7.7	6.1	5.8	5.8	5.6
Unemployment rate:						
Administration forecast	8.9	7.9	7.1	6.4	5.8	5.3
Higher growth scenario	8.6	7.1	5.7	4.5	3.3	2.3
Lower growth scenario	9.2	8.7	8.5	8.3	8.3	8.3

3. Total Deficit, Including Off-Budget Deficit - Fiscal Years; Dollar Amount in Billions

	1982	1983	1984	1985	1986	1987
Receipts	626.8	666.1	723.0	796.6	861.0	925.7
Outlays	725.3	757.6	805.9	868.5	927.0	978.9
Budget Deficit	-98.6	-91.5	-82.9	-71.9	-66.0	-53.2
Off-budget deficit	-19.7	-15.7	-14.3	-11.0	-10.9	-9.3
Total deficit	-118.3	-107.2	-97.2	-82.8	-77.0	-62.5
Range	-113.7 to -122.5	-90.4 to -124.0	-65.0 to -129.4	-34.9 to -130.9	-11.5 to -142.9	+19.5 to -144.7

4. Deficit Reduction Program Assumed in the Above Estimates - Fiscal Years; - Dollar Amount in Billions

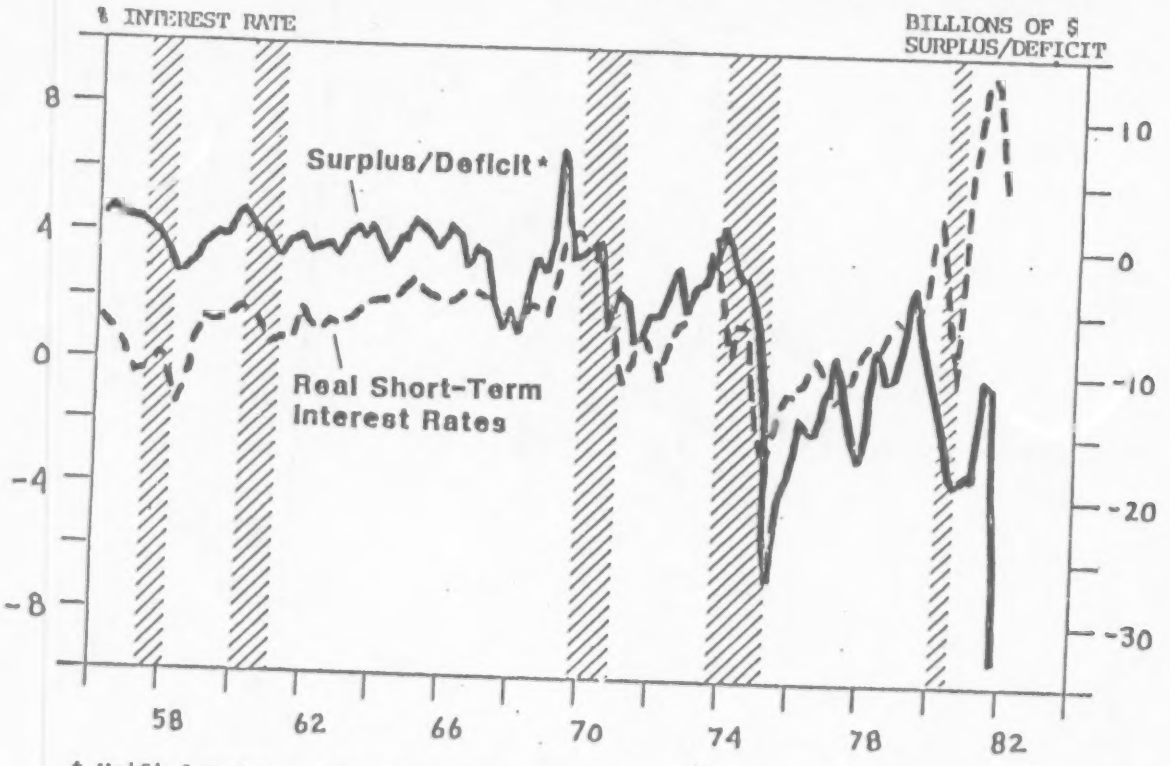
55.9	84.1	99.3	NA	NA	NA

Source: Budget of the U.S. Government for FY 83, February 1982.

COMPARISON OF BUDGET DEFICIT PROJECTIONS
(Dollar Amount in Billions)

	Fiscal Years		
	1982 $	1983 $	1984 $
• Administration Forecast:	98.6	91.5	82.9
• Private Forecasts:			
Lawrence Chimerine (Chase Econometrics)	108	110-130	80-100
Michael K. Evans (Evans Economics)	109	125	116
Kathleen Cooper (Security Pacific)	95-100	100-110	NA
James Frailick (Morgan Guaranty)	105-115	120-140	140-160
Alan Greenspan (Townsend-Greenspan)	98	120	118-135
David Jones (Aubrey G. Lanston)	95-100	120	130
Irwin Kellner (Manufacturers Hanover)	105	95	90
Alan Lerner (Bankers Trust)	95	110-120	130-150
Don Maude (Merrill Lynch)	95-100	130-140	140-150
Allen Sinai (Data Resources)	107.2	108.7	103.6
Gary Shilling (Shilling and Co.)	95-105	100-120	90-110
Robert Sinche (Bear Stearns)	100-105	145-150	150
John Wilson (Bank of America)	100-120	90-100	NA
• Range of Private Forecasts	95-120	90-150	80-162
• Congressional Budget Office	111.0	120.6	128.9

FEDERAL GOVERNMENT SURPLUS OR DEFICIT VS. REAL SHORT-TERM INTEREST RATES



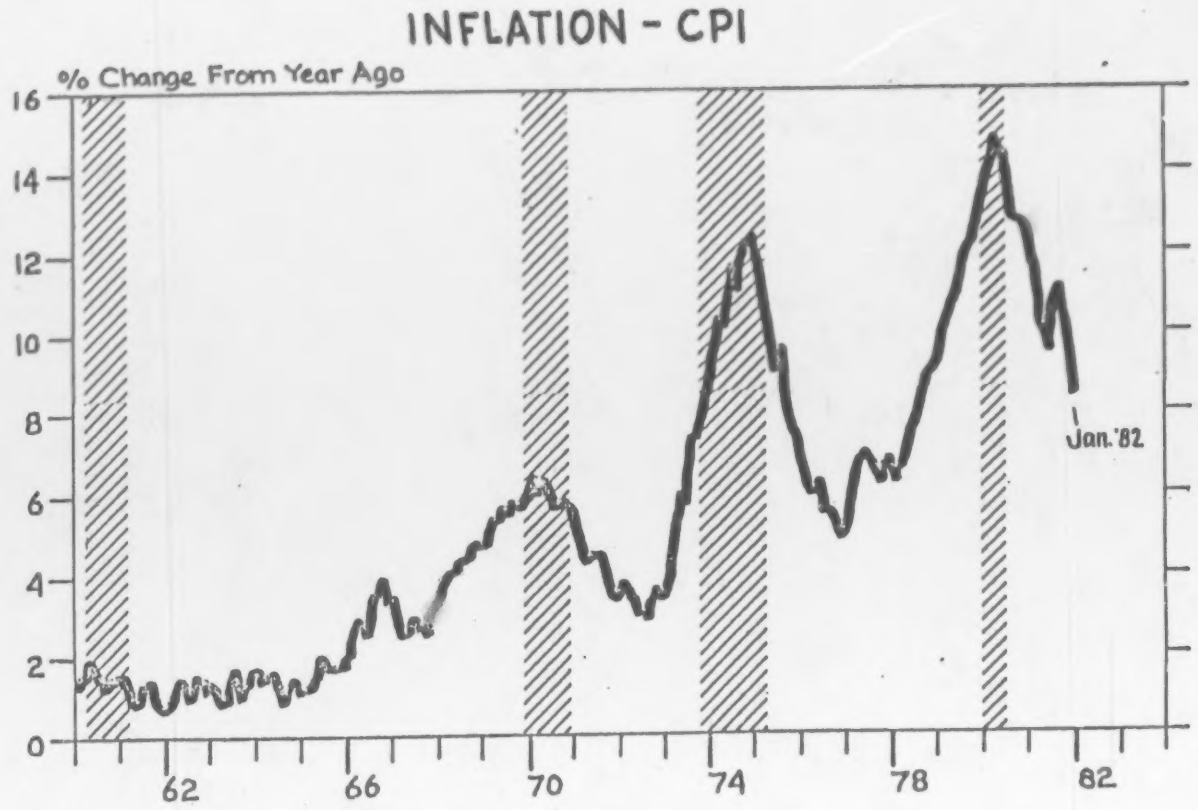
* Unified Budget Basis, Seasonally Adjusted

RECENT TRENDS IN DEBT MONETIZATION
(Dollar Amount in Billions)

Fiscal Year	Unified Budget Deficit	New Federal Borrowing From Public	Federal Debt Purchased by Federal Reserve	Percentage of New Federal Borrowing Monetized
	$	$	$	%
1970	-2.9	5.1	3.6	70.6
1971	-23.0	19.2	7.8	40.8
1972	-23.4	18.5	5.8	31.4
1973	-14.9	19.2	3.7	19.3
1974	-4.7	3.0	5.5	183.3
1975	-45.2	50.8	4.3	8.5
1976	-66.4	82.9	9.7	11.7
1977	-57.9	71.9	10.3	14.3
1978	-48.8	58.8	10.1	17.2
1979*	-27.7	33.6	0.7*	2.1*
1980	-59.6	70.5	5.3	7.5
1981	-57.9	79.3	3.6	4.5

Source: Harris Bank

Comment: * Since October 1979, the Federal Reserve is committed to control the growth of money supply. This means that the Fed will no longer monetize federal debt to stimulate a recovery, as it had done in past cycles.


INFLATION - CPI
% Change From Year Ago
16
14
12
10
8
6
4
2
0
62
66
70
74
78
82
Jan. '82

TOTAL FEDERAL BUDGET SURPLUS OR DEFICIT*
AS A % OF GROSS NATIONAL PRODUCT
(Dollar Amounts in Billions)

Fiscal Year	Amount $	As percent of GNP %
1958	-2.9	-0.7
1959	-12.9	-2.7
1960	.3	.1
1961	-3.4	-.7
1962	-7.1	-1.3
1963	-4.8	-.8
1964	-5.9	-1.0
1965	-1.6	-.2
1966	-3.8	-.5
1967	-8.7	-1.1
1968	-25.2	-3.0
1969	3.2	.4
1970	-2.8	-.3
1971	-23.0	-2.2
1972	-23.4	-2.1
1973	-14.9	-1.2
1974	-6.1	-.4
1975	-53.2	-3.6
1976	-73.7	-4.5
1977	-53.6	-2.9
1978	-59.2	-2.8
1979	-40.2	-1.7
1980	-73.8	-2.9
1981	-78.9	-2.8
1982**	-118.3	-3.8
1983**	-107.2	-3.1

* Total Federal Budget Surplus or Deficits = Federal Unified Budget Deficits or Surplus Plus Off-Budget Deficits

** Administration Estimates

Source: Budget of the U.S. Government for Fiscal Year 1983, February 1982.

HIGH REAL INTEREST RATES

	Eurocurrency*	1982 Inflation**	Real Interest Rates
U.S.	15.3	7.7	7.6
Canada	15.3	11.0	4.3
W. Germany	10.2	5.7	4.5
France	15.2	14.6	.6
U.K.	14.5	10.1	4.4
Italy	21.3	17.0	4.3
Japan	6.3	4.2	2.1

* February 19, 1982 Three-Month Eurocurrency Rates

** Annual Average Percent Change in CPI from GTE January 29, 1982 Weathervane

Exhibit VII

MONEY SUPPLY GROWTH BELOW TARGETS DURING MOST OF 1981

(Weekly Averages of M1)

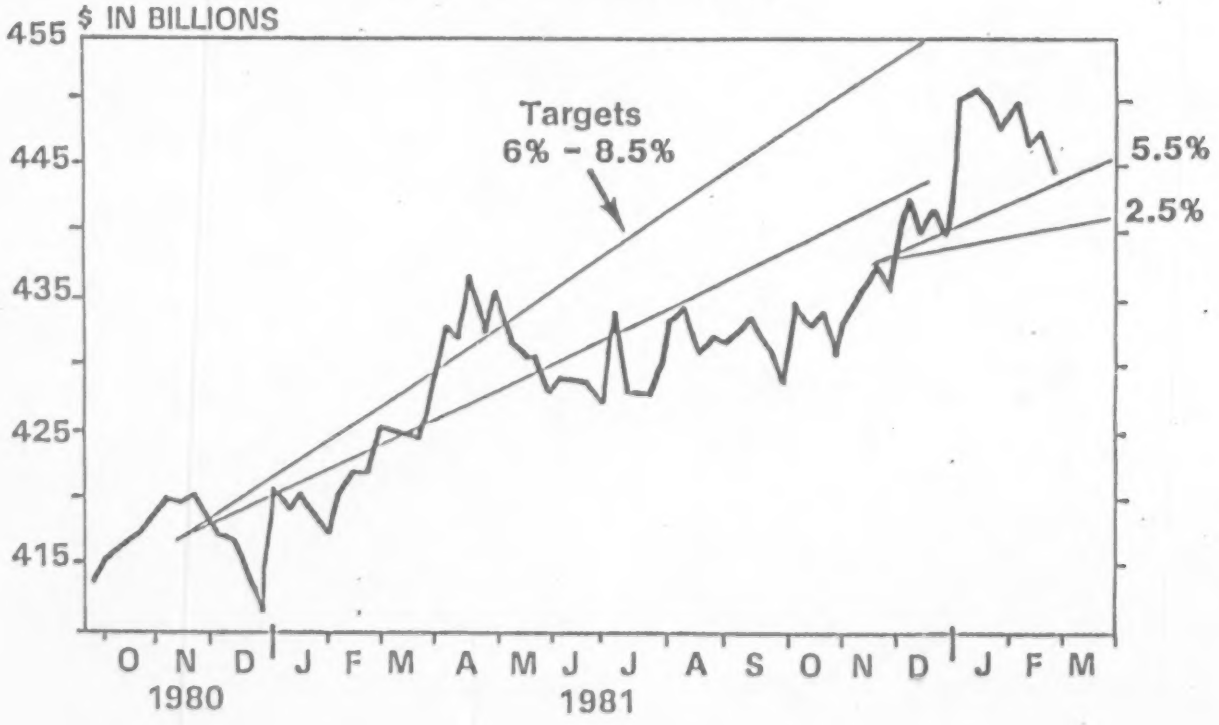


EXHIBIT VIII

Chairman ROSTENKOWSKI. Mr. Baldwin, you may proceed.

STATEMENT OF CHRISTOPHER W. BALDWIN, DIRECTOR OF TAXES, GANNETT CO., INC., ON BEHALF OF THE ROCHESTER TAX COUNCIL

Mr. BALDWIN. Mr. Chairman, I am Chris Baldwin, and I appear before you today on behalf of the Rochester Tax Council.

The Rochester Tax Council is a voluntary organization of companies having strong affiliations with the Rochester, N.Y., area, and it includes companies such as Kodak, Xerox, Sybron, Bausch & Lomb, and other large employers in the area. The Council has regularly studied and addressed proposed Federal tax legislation, and has frequently testified before this committee.

Consistent with the Council's past practices, today's testimony will report our position on the administration's proposals which are relevant to our members. While we must strongly object to some aspects of the administration's proposals, there are others which we can accept even though they are detrimental to many or all of our members, such as the tax exempt revenue bonds.

The Council would have no objections to the proposed changes if the committee should decide to restrict the use and availability of IDB financing of industry projects. On modified co-insurance and construction period interest and taxes, we would have no objections to those suggestions. Withholding on dividends and interest, the Council would have no objection to this proposal if the committee determines that it is cost effective.

However, on the corporate minimum tax, the Council strongly opposes the proposed corporate minimum tax. As economic policy, it is wrong because it confuses and indirectly undercuts key incentives that Congress has put into the tax law, including the accelerated cost recovery system which was the centerpiece of the administration's business tax policy only last year.

Particularly serious is the disallowance of the investment tax credit. Businesses plan their acquisition of depreciable property well in advance of the year in which such property is finally placed in service. At the time when investment tax credit property is ordered, it will normally be impossible to determine whether the business will be subject to the regular or the proposed minimum tax in the year in which the property is actually placed in service. Consequently, the usefulness of the investment tax credit will be in doubt, and the economic incentive intended from this provision will be undercut.

As tax policy, the proposed corporate minimum tax is wrong because it will greatly complicate the computation of the Federal corporate income tax, and will make determination of estimated corporate tax payments much more difficult.

The new proposal will require many companies to calculate and plan on the basis of two different definitions of taxable income, two tax rates, and two sets of available credits. Of particular concern is the added uncertainty in evaluating what economic benefit, and therefore what incentive, is provided by the deductions and credits allowed under the regular tax, but disallowed under the minimum tax.

If, not withstanding the serious economic and tax policy drawbacks of this proposal, Congress does adopt some new form of corporate minimum tax, the Council urges you to modify the Treasury proposal as follows:

The investment tax credit should be allowed as a credit against a minimum tax, except possibly investment tax credits passing to a taxpayer due to safe harbor leases; DISC income should not be attributed to shareholders as an addition to corporate profits. This is the only item in the proposed 14 preferences that involves adding an income item rather than disallowing a deduction.

Any minimum tax base should be limited to normal income plus disallowed deductions. In order to avoid international double taxation, the Treasury proposal would allow the foreign tax credit as a credit against a proposed corporate minimum tax. However, some voices have been raised in Congress questioning this decision.

The Council strongly opposes any disallowance of the foreign tax credit, or other steps to erode this essential element protecting American business from double taxation of the same income. On the accelerated corporate income tax payments, the Council believes the Treasury's proposal is based on an erroneous premise. The ability of corporations to estimate income on a monthly basis is very limited and quite inexact.

We know from direct experience that it is not possible to estimate income with the accuracy required to meet the requirements of the Treasury proposal. The 10-percent leeway for error is much too small. We believe this Treasury premise is highly suspect and should be reexamined. The Treasury proposal would in effect impose a nondeductible penalty of 20 percent on any payments outside of the narrow 10-percent range of error.

This is equivalent to a pretax charge of 37 percent for the use of money, which is unfair and unreasonable. Moreover, the Treasury does not propose making any comparable payment, or indeed any payment, to taxpayers who have in good faith overpaid estimated taxes. Such taxpayers are forced to lend the Government funds on an interest-free basis. The time has come to review entirely this subject. The concept of a penalty where there is a good-faith effort to comply within very narrow guidelines is unfair.

A 20 percent, or prime rate, deductible interest charge should be quite sufficient, and the same rate of interest should be payable by the Government where the taxpayer in good faith has overpaid estimated taxes.

On the completed-contract method, even assuming that some adjustments may be required in the calculation of income on the timing of deductions under the long-term contract method, this combined legislative and regulatory proposal is overkill. It reaches many contracts and taxpayers who are beyond the scope of the Treasury's rationale for this proposal.

For example, we are greatly concerned that this proposal may be applicable to taxpayers who have not elected the completed-contract method. On business energy credits, in view of the existing sunset provisions governing these credits and the long lead time required for most business investments qualifying for these credits, we believe that it would be unfair and poor tax policy to accelerate these sunset provisions.

We appreciate the opportunity to present our views and look forward to working with this committee and your staffs in the continuing evaluation of these proposals.

Thank you.

[The prepared statement follows:]

STATEMENT OF CHRISTOPHER W. BALDWIN ON BEHALF OF THE ROCHESTER TAX COUNCIL

Mr. Chairman, I am Christopher Baldwin, director of Taxes of Gannett Co., Inc., and I appear before you today on behalf of the Rochester Tax Council. Consequently, the views expressed are those of the Rochester Tax Council and not necessarily of Gannett Co. The Rochester Tax Council is a voluntary organization of companies having strong affiliations with the Rochester, New York, area. The council members are:

Bausch & Lomb, Inc.
Champion Products
Gannett Co., Inc.
Garlock, Inc.
Gleason Works
Eastman Kodak Company
The R. T. French Company
Schlegel Corporation
Security New York State Corporation
Sybron Corporation
Xerox Corporation

The council has regularly studied and addressed proposed federal tax legislation and has frequently testified before this committee. We believe the council is particularly well equipped to address these issues of tax policy because its membership is not limited to any particular industry; but includes companies engaged in manufacturing a wide range of diversified products throughout the world, and also a major newspaper and communication chain and a bank. Nevertheless, the council membership is sufficiently limited in number that it can quickly and constructively evaluate tax proposals.

Consistent with the past practices of the council, our testimony today will report our position on the administration's proposals which are relevant to our members. While we must strongly object to at least some aspects of some of the administration's proposals, there are others which we can accept even though they are detrimental to many or all of our members.

To date the administration has not proposed specific statutory language, so that detailed analysis is difficult. Based, however, on the Treasury's general and technical explanations as released on February 26, 1982, our comments and positions are as follows (in the order presented by the Treasury rather than order of importance to the council):

I. *Completed Contract Method.*—Even assuming that some adjustments may be required in the calculation of income and the timing of deductions under the long term contract method, this combined legislative and regulatory proposal is overly broad. It reaches many contracts and many taxpayers beyond the scope of the Treasury's rationale for this proposal. It may surprise the committee to learn that the Treasury proposal would deny the normal rules of the accrual method to taxpayers who have not even elected to use the completed contract method. Such taxpayers are not receiving the benefits of that method, are not receiving the deferral of reporting income under that method, and should not be denied the right to report income and deductions under the accrual method. Whatever justification there may be for requiring taxpayers on the completed contract method to change to the percentage of completion method or the progress payment method, there is no justification for requiring a taxpayer which reports income and deductions from long-term contracts under the regular accrual method to change to one of these two special methods.

We do not possess the knowledge or expertise to address the many other aspects of this proposal, and leave that to parties more directly and deeply involved. However, some of the smaller companies in the council have used the completed contract method in connection with a limited portion of their business. If any changes are required in this area, some exceptions would be in order for smaller companies of the size of these members of the council which report only a limited percentage of their income under the completed contract method.

II. *Business Energy Credits.*—In view of the existing "sunset provisions" governing these credits and the long lead time required for most business investments qualifying for these credits, we believe it would be unfair and poor tax policy to accelerate these "sunset provisions."

III. *Tax-Exempt Revenue Bonds.*—Most of the members of the Council have undertaken projects financed with industrial development bonds. While industrial development bonds appear to have been helpful to the communities issuing them, if Congress believes this avenue for community incentives should be modified as proposed by the Administration, the Council would have no objections.

IV. *Modified Coinsurance.*—This is an issue on which the Council has no knowledge or involvement and, consequently, has no comment.

V. *Construction Period Interest and Taxes.*—While this proposal would defer certain deductions for members of the Council, we have no serious objections to it.

VI. *Corporate Minimum Tax.*—The Council opposes the proposed corporate minimum tax. As economic policy, it is wrong because it confuses and indirectly undercuts key incentives that Congress has put into the tax law, including the Accelerated Cost Recovery System (ACRS) which was the centerpiece of the Administration's business tax policy only last year. Particularly serious is the disallowance of the investment tax credit. Businesses plan their acquisition of depreciable property well in advance of the year in which such property is finally placed in service. At the time when "Section 38 property" is ordered, it will normally be impossible to determine whether the business will be subject to the regular or the proposed minimum tax in the year in which the property is actually placed in service. Consequently, the usefulness of the investment tax credit will be in doubt, and the economic incentive intended from this provision will be undercut, not only in those situations where the minimum tax is due, but also in the very large number of cases in which the taxpayer will be uncertain when an order is placed about the usefulness of the credit. For these taxpayers, the impact will be much the same as an announcement by the Administration that it is considering a repeal or reduction of the investment tax credit. Taxpayers being uncertain of the availability of the credit will discount this incentive in making their capital investment plans.

As tax policy, the proposed corporate minimum tax is wrong because it will greatly complicate the federal corporate income tax. As noted by Treasury, the present corporate minimum tax affects few corporations. The new proposal will require most companies (other than those protected by the $50,000 exclusion) to calculate and plan on the basis of two different definitions of taxable income, two tax rates, and two sets of available credits. The actual double calculation is not the most serious part of this problem; more significant are the problems of estimating tax payments and, particularly, of evaluating what economic benefit, and therefore what incentive, is provided by the deductions and credits allowed under the regular tax, but disallowed under the minimum tax. Also, the proposed corporate minimum tax credit carryover would have the effect of reordering credits in a way which is difficult to predict. Record keeping for carryovers is already quite complex where audits redetermine credits and create credit carrybacks; this exacebates this problem.

Aside from companies that would regularly pay only the minimum tax, the treasury recognizes that the net effect of the minimum tax is to accelerate the time of tax payments. Is this acceleration sufficient policy justification to support the complexity and undercutting of intended economic stimuli?

If some changes in the corporate tax, and in particular in those items impacted by the proposed corporate minimum tax, are deemed necessary by the Administration or by Congress, these changes should be addressed directly by a reduction or repeal of such items, and not by introducing new and duplicative corporate tax systems.

If, not withstanding the serious economic and tax policy reason drawbacks of this proposal, Congress does adopt some new form of corporate minimum tax, the Council urges you to modify the Treasury proposal as follows:

(1) For reasons stated above, the investment tax credit should be allowed as a credit against the minimum tax (except possibly investment tax credits passing to a taxpayer under Section 168(f)(8)), and

(2) DISC income should not be attributed to shareholders as an addition to "corporate profits." With the possible exception of a limited shipping subsidy item, this is the only item in the proposed fourteen preferences that involves adding an income item rather than disallowing a deduction. Any minimum tax base should be limited to normal income plus disallowed deductions. Furthermore, this DISC proposal introduces a number of policy questions not answered by the Treasury presentation. If the income of the DISC is added to its parent's taxable income in one year under the minimum tax, will the same income be taxed again to the parent under the regular tax when it is distributed by the DISC to the parent in a later year? What

impact will this preference have on the earnings and profits of the parent and of the DISC? How will the foreign tax credit limitation be calculated?

(3) The Treasury proposal does allow the foreign tax credit as a credit against the proposed corporate minimum tax, but some have raised a question about this allowance. The Council strongly opposes any disallowance of the foreign tax credit or other steps to erode this essential element protecting against international double tax.

VII. *Withholding on Dividends and Interest.*—The members of the Council pay large amounts in dividends and interest which would be subjected to the proposed withholding tax. This proposal would certainly increase costs to payors. Nevertheless, if this Committee and the Congress conclude that such withholding is required to avoid substantial revenue losses and that the cost of such withholding is not disproportionate to the revenue raised, the Council would have no objections to this proposal.

VIII. *Accelerated Corporate Income Tax Payments.*—The Council believes this proposal is based on a totally erroneous premise. The Treasury's General Explanation states, "Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent without any penalty." The ability of corporations to estimate income on a monthly basis is very limited and quite inexact. The members of the Council, which include two of the largest corporations in America, know from direct experience that it is not possible to estimate income with the accuracy required to meet the requirements of the Treasury proposal. We believe this Treasury premise is highly suspect and should be reexamined.

The Treasury proposal would impose a nondeductible penalty of 20 percent on any payments outside of a narrow 10 percent range of error. This is equivalent to a charge by the government of 37 percent for the use of money. Such a charge is unfair and unnecessary. Treasury does not propose making any comparable payment, or indeed any payment, to taxpayers who have in good faith overpaid estimated taxes. The government has use of these funds on an interest free basis.

At the same time the Treasury proposal would diminish the limited safe-haven rule for larger corporations. At a minimum, no increase in the percentage of estimated tax payments should be made without clear and reasonable safe-haven rules which can assure corporations that specific payments will provide protection against penalties.

The time has come to review entirely this subject. The concept of a "penalty" where there is a good faith effort to comply within very narrow guidelines is quite antediluvian and unfair. A 20 percent deductible interest charge is quite sufficient, and this same rate of interest should be payable by the government where the taxpayer in good faith has overpaid estimated taxes.

We appreciate the opportunity to present our views and look forward to working with this Committee and your staffs in the continuing evaluation of these proposals.

Chairman ROSTENKOWSKI. Mr. O'Brien, you may proceed.

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. O'BRIEN. Thank you, Mr. Chairman. Good morning. And members of the committee, as well.

I am Edward I. O'Brien, president of the Securities Industry Association. I presume my written statement will be incorporated in the record. We are going to limit our comments today to a few particular areas.

First of all, SIA wholeheartedly endorses the Treasury Department's determination to close the tax gap attributable to noncompliance with Federal income tax laws. However, steps to increase compliance must be realistic in terms of the economics and operational feasibility. We believe the 5 percent withholding proposal is effective on both grounds.

Over 80 percent of all interest and dividend payments made to individuals are already covered by information returns. According to the IRS, taxpayers voluntarily reported 96.7 percent of their

dividend and interest income covered by information returns in 1975, and 97.3 percent in 1976. Where an information system is in place and operating, it stimulates virtually full compliance with the tax laws. The existing reporting system's efficiency in detecting nonfilers and underreporters should really be improved, if possible.

Exemption certificates and wage and estimated tax adjustments mitigate but do not eliminate the problem of overwithholding. In 1978, there were 2.7 million nontaxable returns filed by individuals with interest payments, and 700,000 with dividend payments. Thus, millions of exemption certificates would be required, generating boundless paperwork for both corporations and financial intermediaries. On the other hand, taxpayers who underreport will probably not be deterred by a token 5 percent withholding.

Extending withholding to cover bearer obligations will yield more inequity than revenue. Most buyers of such instruments will be overwithheld, while unscrupulous individuals will continue to evade taxes and detection by selling prior to the payment or maturity date.

Withholding proposals would be costly and unproductive and an exercise in futility, we believe. The proposal also exacerbates operational problems when stocks or bonds are sold prior to the record date. Time often precludes transferring the stock or the bond by the actual record date. A dividend or an interest claim adjustment results because the seller received a payment he is not entitled to.

This problem already necessitates about 56,000 account adjustments every day. Withholding compounds the problem by adding additional parties and requiring additional computations. The absorption of losses from claim adjustments alone we estimate will cost the industry somewhere between $30 and $50 million annually.

An alternative approach to withholding would expand brokers' reporting requirements to include capital gains or gross proceeds of sale. The expanded reporting is justified by placing in the same category transactions in real estate, collectibles, depreciable property, and other assets with those in securities or commodities.

In fact, we are convinced, and in fact we believe it is generally acknowledged, that the reporting and payment of tax on securities transactions is markedly higher than in the case of the other assets. Moreover, some portion of the noncompliance is due to certain technical errors which would not be cured by information reporting.

The precise impact on the securities industry cannot at this time be gaged very accurately because the details of the reporting requirements are not known. But the costs in time and money would be substantial and should be weighed against the IRS' ability to process new documents and collect significant revenues.

Industry experts estimate that to set up withholding alone would cost about $1.20 per customer account. Given over 30 million shareholders, this proposal would entail millions of dollars in additional expense. Our supplemental statement will provide detailed estimates of the time and cost elements of this, as well as an elaboration of the operational problems which it would impose.

While not included in the administration's proposal, SIA strongly supports reduction of the capital gains holding period as a method

of increasing Federal revenues and investment. A survey has just been completed and conducted on behalf of the SIA by the Opinion Research Corp., and it is attached to our statement. It shows that the 1-year holding period costs the Treasury revenues in the past 2 years; 31 percent of the surveyed executives reported an average decline of $15,700 in the value of assets that they plan to sell for long-term capital gains in the second 6 months of ownership.

If only 10 percent of the individuals in that same income group had been able to realize gains in light of the 6-month period, we can see that the Treasury revenues would have been increased between $470 and $590 million. Experience disproves the $350-million static gain estimated in 1976 as a result of lengthening the holding period to 1 year.

The survey demonstrates dramatic increases in investment under a shorter holding period. Again, if 10 percent of all the individuals on the same income classes of surveyed executives followed similar investment behavior, the total increase in investment would be around $50 billion during the first year. While this figure may seem staggering, it represents just 7.5 percent of the increase in personal financial holdings from 1979 to 1980.

Mr. Chairman, that concludes my oral statement. If there is any way I can help with an answer to a question, I will be glad to do so.

Thank you.

[The prepared statement follows:]

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the committee. I am Edward I. O'Brien, and I am appearing today as President of the Securities Industry Association. I appreciate the opportunity to participate in the committee's hearings on the Administration's tax proposal.

SIA represents nearly 550 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 32 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporation and governmental units at all levels.

SIA applauds and wholeheartedly endorses the Treasury Department's determination to close the "tax gap" attributable to non-compliance with the Federal income tax laws, which according to IRS estimates is rapidly approaching the $100 billion mark. As Congress and the Administration seek to narrow triple-digit budget deficits in the next several fiscal years, it behooves the government to give top priority to the pursuit of taxpayers who do not pay their fair share of the tax burden. Our self-assessment system cannot exist without voluntary compliance on the part of the taxpaying public. Substantial non-compliance destroys the fabric which holds that system together, namely

taxpayers' perception of its fairness and their conviction that everyone else also carries his or her share of the tax load.

However, since efforts to close this tax gap will impose additional responsibilities upon taxpayers and third party payers, steps to increase compliance must be realistic in terms of both economics and operational feasibility. We believe the 5 percent withholding proposal is defective on both grounds.

REVENUE ESTIMATES

The Treasury Department estimates that taxpayers fail to report about $20 billion of taxable interest and dividends annually. In fiscal year 1983, 75 percent of the estimated $2 billion revenue gain from withholding would be due to an interest-free loan from taxpayers rather than to increased compliance. The department also estimates that the implementation of a 5 percent withholding tax on interest and dividends will produce additional revenues aggregating $8.1 billion for fiscal years 1983-87. However, $2.4 billion of this sum would be realized through acceleration of payments, leaving only $5.7 billion as representing increased compliance.

We do not know how these estimates were made. However, according to Treasury's own calculations, over 80 percent of all interest and dividend payments made to individuals are already covered by information reporting. (Treasury Department's General and Technical Explanations of Tax Revisions and Improved Collection and Enforcement Proposals, released February 26,

1982.) Furthermore, according to recently released IRS statistics, for tax year 1975 individual taxpayers voluntarily reported 96.7 percent of their interest and dividend income covered by information documents. For tax year 1976 the comparable voluntary compliance rate was 97.3 percent. (IRS Study of the Information Returns Program (IRP) Tax Years 1975 and 1976, released July 1981.)

These figures clearly indicate that where an information reporting system is in place and operating, it stimulates virtually full compliance with the tax laws. It is true that voluntary compliance levels in the area of wages subject to withholding were even higher -- 99.9 percent in 1975 and 99.8 percent in 1976. However, we believe that these slight differences are not so much due to the presence of withholding as to the more complex and technical problems associated with the determination of whether, when, to what extent, and to whom passive investment income is taxable.

In short, we suggest that a system which brings about the voluntary reporting of over 97 cents out of each dollar of dividend and interest income received is about as efficient as one could reasonably hope for. The American taxpaying public and the financial community should not be saddled with the cumbersome, expensive, and often counterproductive and unnecessary features connected with the imposition of a withholding tax at the source. Instead Congress should provide IRS with the resources required to strengthen its information

document matching and follow-up capabilities, not only in the interest and dividend areas, where compliance levels are already high, but more importantly, in those income categories such as non-farm business activity where most of the tax gap is reportedly concentrated.

We believe the withholding proposal and the increased reporting alternative discussed below, shift the burden from the public to the private sector, at a far greater cost than anticipated by the government. The proposals impose several new operational problems on the industry, as well as exacerbating some problems that the industry has spent years trying to overcome to no avail. Despite the comprehensive computerized systems the industry has implemented in the past decade, the volatile nature of the securities business subjects firms to severe operational strains from time to time. Much operational detail is still dealt with manually on an account-by-account basis.

DIVIDEND CLAIM ADJUSTMENTS

One of the most perplexing of these problems is the dividend interest claim adjustment, which results when the holder of record is not the beneficial owner of a security. On an industry-wide basis, it is estimated that this problem entails about 56,000 account adjustments a day. Half the work of dividend departments at brokerage firms is directed to remedying this problem. Compounding of this situation by introducing the problems of tax liability would be costly and would delay

claiming and receiving funds, which could disccurage investors. Moreover, a certain amount of these funds are never collected by the brokerage house and are absorbed after the credit is made to the beneficial owner. Industry experts project that the withholding proposal could result in additional costs of $2,000-$5,000 a month for an average size firm. In fact, such costs may persuade some firms to depart from the individual market altogether.

The complexities of this typical and recurring problem call for some elaboration. In the case of registered stock sold prior to the record date for dividend payments, the time factor often makes it impossible to transfer the stock out of the seller's name by the actual record date. Therefore, the seller receives a dividend payment from the paying agent to which he is not entitled while the buyer does not receive a payment to which he is entitled. For the medium-size firm, it is estimated that slightly under 2 percent of their accounts receive payments to which they are not entitled to, necessitating later reconciliation of the records of both buyer and seller. The withholding proposal compounds this situation by adding additional parties and requiring additional computations.

BEARER OBLIGATIONS

The administration's withholding proposal would be extended to corporate coupon bonds, short-term corporate discount obligations, such as commercial paper, bankers acceptances, and repurchase agreements, as well as to U.S. government obligations,

heretofore exempted from the information reporting requirements. The new rules would apply to obligations held by unincorporated holders only, and withholding would occur at the time the interest coupons are paid, or in the case of short-term discount obligations, at the time of maturity.

The imposition of a withholding requirement for these instruments would require the development of new tracking and record-keeping procedures by the securities industry and other financial intermediaries. Moreover, imposing the entire 5 percent withholding tax on the interest payment date or maturity date would constitute an unjust burden to noncorporate investors in these instruments, since every buyer of such instrument in the secondary market will be the victim of overwithholding. On the other hand, holders who dispose of their obligations before maturity or the interest payment date escape being withheld upon. Thus, under the Treasury proposal unscrupulous investors could continue to evade detection and withholding tax liability by transferring their shares immediately prior to the interest payment or maturity dates. For these reasons, we believe that adoption of Treasury's withholding proposal in this area would be a costly and unproductive exercise in futility.

The Internal Revenue Service has not yet released any study results specifically focusing on compliance by holders of bearer obligations. It seems to us that before the Congress even considers any further reporting and/or withholding requirements covering unregistered obligations, the Treasury Department should

be required to convincingly demonstrate the extent and magnitude of taxpayer noncompliance in this area.

OVER- AND UNDERWITHHOLDING

The administration's proposal contemplates the filing of exemption certificates if certain highly restricted conditions are satisfied. Taxpayers not meeting these criteria may avoid overwithholding by adjusting their estimated tax payments or the amount of taxes to be withheld from their wages. In spite of these features many taxpayers, through inadvertence, oversight or lack of awareness, will fail to avail themselves of these options, and thereby be subject to overwithholding. Conversely, a 5 percent withholding tax will be less than the actual tax liability for individuals with other taxable income. Their marginal rate of taxation will range from 11 percent to 50 percent. Withholding will be no more effective than reporting in collecting tax from those who inadvertently or deliberately underreport, or fail to report, dividend and interest income.

Under the administration's proposal, individuals will not be allowed to file exemption certificates to take account of the $100/200 dividend exclusion. Industry experts estimate that for just one average-size securities firm, about 100,000 retail accounts generate dividend payments below the exclusion floors. Projected to industrywide proportions, the data suggest that millions of taxpayers will be exposed to overwithholding. Despite exemption certificates and wage withholding adjustments, the withholding proposal will still result in an exacerbation of

the existing overwithholding problem. Many taxpayers, particularly in the lower income groups, will be confused or simply unaware of the steps to take to offset withholding of their dividends and interest. This will create a most undesirable hardship for individuals relying on interest and dividend income for support. Table I on the next page shows the percentage of returns in 1978 within each AGI group where overwithholding took place. Even before the current withholding proposal, there was overwithholding of 82 percent in the under $10,000 and 76 percent for $10,000 to under $14,000 group. For all returns, 73 percent reported overpayments. In 1978, returns with adjusted gross income under $30,000 accounted for 68 percent of interest and 36 percent of dividends reported on individual income tax returns.

CAPITAL TRANSACTIONS REPORTING

An alternative approach to withholding is contained in H.R. 5829 and S.2198. These bills would expand the requirement for information reporting by brokers to include capital gains in commodities and securities transactions.

The administration claims that the federal government is short-changed by over $9 billion annually as a result of discrepancies in the reporting of capital gains. Supposedly, out of every tax dollar due on transactions resulting in capital gains, only 56 cents is being voluntarily reported. Neither the facts these estimates are based on nor the technical methodology used to develop these calculations have ~~not~~ been released to the

Table I

AGI Income Group	Returns with Overpayments: No. of Returns (mils.)	Returns with Overpayments: % of Returns In Income Group	Returns Reporting Interest and Dividends: Interest: No. of Returns (mils.)	Interest: % of int. Paid	Dividends: No. of Returns (mils.)	Dividends: % of Div. Paid
Under $10,000	34.2	82%	14.7	24.2%	3.3	10.0%
$10,000-$14,000	8.9	76	5.7	11.4	1.3	5.7
$14,000-$20,000	9.9	71	8.1	14.5	1.9	7.6
$20,000-$30,000	8.7	62	10.2	17.8	3.1	12.3
$30,000-$50,000	3.2	49	5.7	16.3	2.6	16.4
$50,000-$100,000	0.5	33	1.4	9.3	1.0	18.0
$100,000 plus	0.1	28	0.3	6.5	0.4	30.0
Totals	65.5	89.8	46.1	100.0	13.6	100.0

public. Undoubtedly, the figures include capital gains on real estate transactions, collectibles, depreciable property used in trade or business, and a host of other transactions unrelated to securities or commodities. It also seems plausible that these estimates encompass not only errors of omission, but also errors of commission, such as using an incorrect tax basis for the property sold, or reporting the gain in the wrong year. Also to be considered is the wide spectrum of technical and interpretative issues which, we believe, predominate the field of capital gains controversies between taxpayers and the Internal Revenue Service.

There is no doubt that reporting of capital gains or proceeds of sales would impose extensive record keeping burdens upon the securities industry. Until such time as the details of the reporting requirements are spelled out, we are unable to describe the precise impact of the proposal on the industry's operations and costs. But these costs in time and money would be substantial, and should be weighed against the IRS's ability to process the new documents in order to collect significant revenues. The data released to date does not indicate how much of the $9 billion gap the proposed system would close.

CAPITAL GAINS HOLDING PERIOD

SIA strongly supports the reduction of the capital gains holding period, a proposal which would not impose a burden on the securities industry or the individual investor. Most importantly, a recent survey conducted by Opinion Research

Corporation for SIA showed that the one-year holding period has lost revenues for the Treasury in the past two years. Surveyed executives reported an average decline of $15,700 in the value of assets that they planned to sell for long-term capital gains in the second six-months of ownership. Assuming that only 10 percent of the individuals in the same income group experienced similar trends in capital gains, the estimated Treasury revenue loss ranges between $470-$590 million. This is in striking contrast to the $350 million "static" gain estimated by Treasury to be derived from lengthening the holding period from six months to one year.

Based only on the executives in our survey -- without extrapolating to the universe of investors -- the increased investment stimulated in eleven asset choices is most impressive. During the first year of a six month holding period, new or increased common stock investment generated would be $4.1 million. Assuming that 10 percent of all individuals in the same income class as the surveyed executives would follow similar investment behavior, the total increased investment would be around $50 billion during the first year. While this figure may seem staggering, it represents just 7.5 percent of the increase in personal financial holdings from 1979-80.

We have long believed that selective removal of tax disincentives on investment can generate favorable developments for the economy. The capital gains tax cut in 1978 is proof positive. There is no dispute that this cut led to increased tax

revenues in 1979. Recently released preliminary IRS income data show that sales of capital assets in 1980 were virtually the same as in 1979, suggesting that the stimulative effect of the tax cut led to increased capital gains revenues in 1980 as well. Of course, there are many other trends which document the successful track record of the 1978 capital gains tax cut.

CONCLUSION

The administration has not adequately demonstrated the need for a withholding system to be superimposed upon an already efficiently functioning system of information reporting. To the extent the existing system is still short of its ultimate objective, we believe additional steps should be taken to improve its effectiveness. A withholding system is not easily implemented, and would greatly add to the complexity and cost of the present record-keeping process. Many more forms will have to be exchanged between financial intermediaries and the IRS, and the administrative costs for government and industry will be significant.

New reporting of capital transactions will also increase costs and record-keeping burdens. Before such a massive undertaking is launched, Congress and the industry must have convincing evidence that the proposal would close a substantial portion of the $9 billion gap.

Estimates vary industrywide as to the time required and expense involved in implementing withholding or the additional

reporting requirements. Industry experts have estimated that to establish the withholding provision alone would cost about $1.20 per customer account. Given over 30 million shareholders, this proposal could entail millions of dollars in additional expense for the industry and investors. Government staff has indicated a willingness to discuss the problems posed by these proposals with industry technicians and SIA is composing a group of such experts. In addition, our supplemental statement will provide detailed estimates of time and cost elements as well as an elaboration of the operational problems posed.

EXECUTIVES' INVESTMENT RESPONSES TO CHANGING THE HOLDING PERIOD FOR TAX TREATMENT OF CAPITAL GAINS

A Securities Industry Association
Research Report Based on a Survey
Conducted by Opinion Research Corporation
March 1982

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SUMMARY OF FINDINGS

1. Restoration of the six-month holding period to qualify investment profits for treatment as capital gains would significantly stimulate needed investment, according to a survey of 568 executives.
2. Over half the executives — 53% — said they would increase investment in one or more of eleven investment vehicles during the first year a six-month holding period was in effect. This conforms to findings from a similar survey undertaken in October/November 1979 in which 48% of the executives said they would make new or increase existing investments if the holding period were reduced.
3. In terms of investment vehicles, common stocks were by far the most popular, with almost 40% of the executives indicating they would make additional or new purchases. The mean value of increased investment in equities projects to about $18,700.
4. Initial public offerings of common stocks were the second most popular vehicle for increased or new investment under the six-month holding period. Almost 15% of the executives reported they would make *new* investments in initial public offerings. The average increase that would be invested in such issues was around $10,500.
5. Of those who responded positively to a reduced holding period, about one-third indicated they would increase their investments by at least 50% over what they would invest under the current holding period.

CHART 1

EXECUTIVE REACTIONS TO A SIX-MONTH HOLDING PERIOD DURING THE FIRST YEAR

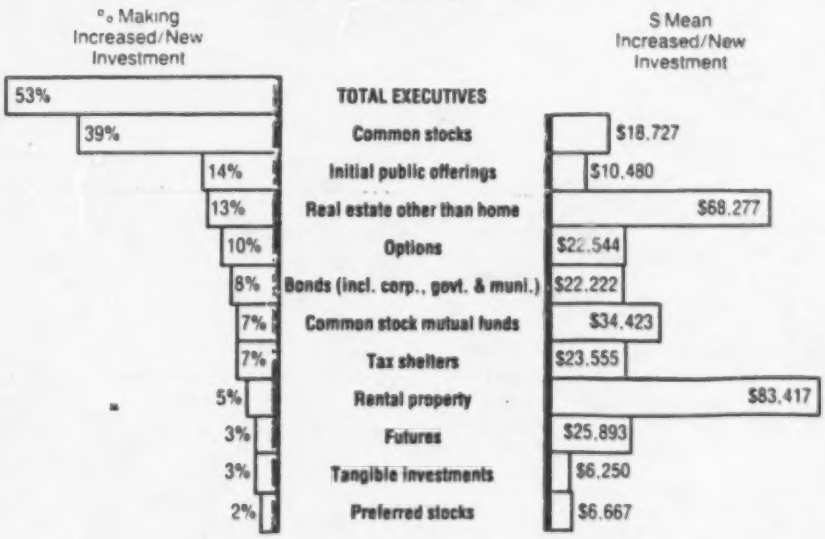
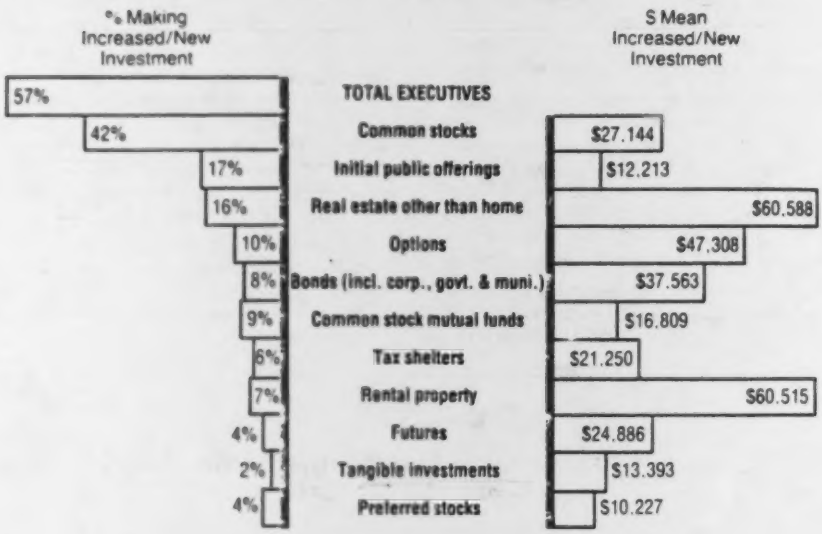


CHART 2

EXECUTIVE REACTIONS TO ELIMINATION OF THE HOLDING PERIOD DURING THE FIRST YEAR



6. During the past two years, nearly one-third—31%—of the executives reported assets they planned to sell declined in value because of changing market conditions in the second six months of ownership. The average decline due to holding assets for at least one year to qualify for capital gains treatment was $15,714.

7. Treasury losses estimated at $470-$590 million annually may have resulted from such declines in realized gains (and tax liabilities) occurring on assets being held between six months and one year to qualify for capital gains treatment.* This contrasts with an estimated $350 million "static" revenue gain claimed following enactment of the lengthened holding period in 1976.

8. As expected, complete elimination of the capital gains holding period drew a slightly more favorable investment response—57%—than a reduction to six months. For almost all investment vehicles, the percentage of executives willing to invest as well as the mean investment increased with complete elimination of the holding period.

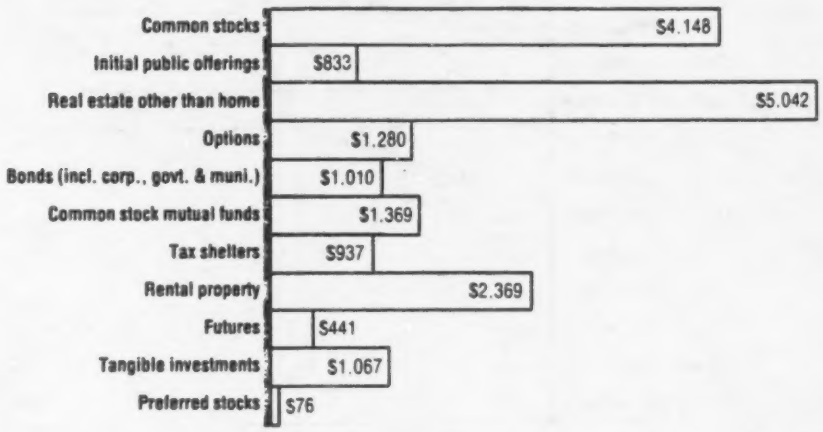
9. Common stocks were again the most popular investment vehicle, chosen by 42% of the executives. These executives would invest, on average, an additional $27,145 if the holding period were eliminated.

*Assumes 10% of taxpayers falling in the same AGI class ($50,000-$100,000) as the average of those reporting losses in the sample experienced similar asset value declines, and that 20-25% tax rates were applicable to such individuals' gains.

CHART 3

TOTAL NEW/INCREASED INVESTMENT GENERATED UNDER A SIX-MONTH HOLDING PERIOD DURING THE FIRST YEAR

(In $ Thousands)



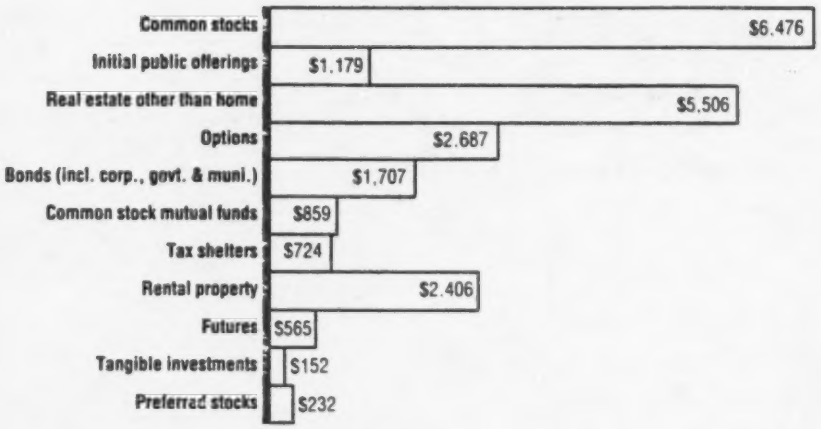
10. The potential impact of reducing or eliminating the holding period for increased investment in most investment vehicles is impressive. Based only on the executives surveyed (without extrapolating to the universe of investors), during the first year of a six-month holding period, new or increased common stock investment of $4.1 million would be generated. (See Chart 3.) Of the eleven investment vehicles, total funds flowing to common stocks were topped only by real estate. With elimination of the holding period, common stock investment jumped 56% to $6.5 million during the first year. (See Chart 4.) Common stocks would receive the largest amount of new funds under a complete elimination, outranking even real estate as the most favored investment in terms of total new dollars committed. Funds flowing to initial public offerings also increased significantly, assuming elimination of the holding period, to $1.2 million from $833 thousand under a six-month holding period.

11. Assuming that 10% of all individuals in the same income class as the surveyed executives would follow similar investment behavior, total new and increased investment would be around $90 billion during the first year, or 7.5% of the increase in personal financial holdings from 1979-1980.

CHART 4

TOTAL NEW/INCREASED INVESTMENT GENERATED BY ELIMINATION OF THE HOLDING PERIOD DURING THE FIRST YEAR

(In $ Thousands)



Overall, the survey indicates that the capital gains holding period can be a serious impediment to investment and, consequently, may be costing the Treasury millions in lost tax revenues. A significant amount of new or increased investment would be stimulated by the reduction or removal of the one-year holding period.

INTRODUCTION

From the early 1940s through 1976, the required holding period was six months for capital gains to be defined as long term for tax purposes. In 1976, Congress approved a tax bill that included provisions lengthening the holding period to nine months in 1977 and to one year in 1978.

The one-year holding period has been the subject of controversy since its passage. The debate has intensified in recent years, given the increased volatility in the capital markets. Individuals involved with the securities markets as issuers, investors, or intermediaries, believe that a one-year holding period is a major disincentive to investment, limiting the aggregate flow of funds into U.S. capital markets at a time when such investment is sorely needed and reducing the market's ability to allocate capital efficiently.

Accordingly, proposals to reduce the holding period to six months have periodically been considered since 1978. Most recently, the Administration's Economic Recovery Tax Act of 1981 included a provision to reestablish the six-month holding period up until the final stages of the bill's passage.

One major objection to returning the required holding period to six months is based on concern about reducing federal tax revenues. Government staff have projected revenue losses in millions of dollars if the holding period were reduced to six months. Nobody is more aware of the problem posed by a widening budget deficit than the securities industry. However, we believe that the revenue loss estimates are relatively small[1] and certainly questionable as they are based mainly on static analysis.

Similar estimates were made concerning the capital gains tax reduction in 1978, with Treasury officials initially projecting losses in revenues exceeding $2 billion. Actual tax return data show that the revenues received from capital gains taxes since 1978 were far beyond the expectations of the Treasury and members of Congress: *tax returns show that the 1978 capital gains tax cut actually generated funds for the government.* The difference between the estimated and actual revenue impact of the 1978 tax cut underscores the problems involved in projecting revenues without taking into account the dynamics of investor behavior.

There is little doubt that investors are sensitive to the holding period and the effective tax rates on capital gains. Based on the last published data on capital gains realized by holding period — 1973, the value of gains realized increased 25% in the seventh and eighth months as compared to the fifth and sixth months.[2] Thus, investors evidenced a significant awareness of the holding period requirement. If the holding period were reduced, we believe investors would definitely increase realizations. To ascertain the dynamics of investors' response to a change in the holding period, SIA commissioned Opinion Research Corporation (ORC) to conduct a survey among investors to answer three basic questions:

(1) How would investors respond to a reduction in the holding period from twelve to six months? (2) Have investors found that gains have diminished or actually turned into losses when retaining assets from six to twelve months during the past two years? and (3) How would investors respond to a complete elimination of the holding period?

To investigate these questions, ORC included a series of questions in its quarterly Executive Caravan Survey, a research vehicle sponsored by multiple clients. The findings are based on personal interviews with 568 executives drawn from a sample of the 500 largest manufacturing companies and the 50 largest non-manufacturing companies. These interviews were conducted between October 20 and November 19, 1981.

In the interviews, respondents were not told that

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[1] The 1976 Conference Report estimated that Treasury tax revenues would increase over the period fiscal 1978 – fiscal 1981 by about $349 million per year under a one-year holding period. This seems minimal in the context of an almost $3 trillion economy in which deficits of $100 billion or more are being discussed.

[2] A six-month holding period was in effect at this time.

these proposals were being studied by SIA. The use of the Executive Caravan was considered to be well suited for evaluating the potential responses to lifting tax disincentives on investment, for several reasons:

1. The persons interviewed are almost all shareholders; more than nine in ten currently own stock, and nearly all the rest have owned stock in the past.
2. Many also own a wide range of other investments, such as real estate, mutual funds, savings certificates and tangible investments.
3. In terms of total securities holdings, the *average* executive owns around $97,000 of stocks, bonds, mutual funds, and other securities.
4. As business people, they are probably more accustomed to financial matters such as tax regulations, investment alternatives, etc., than the average individual. Therefore, they represent a particularly knowledgeable group on whom to test any tax proposal relating to individual investment.

By understanding the attitudes and preferences of the executive community, it should be possible to make judgments, although not precise predictions, about the overall impact of any tax proposal on the investing public. In addition, there is a definite consistency of executive opinion on the capital gains holding period, as evidenced in comparing this survey with a similar one conducted in 1979 by ORC for SIA.

DETAILED FINDINGS

IMPACT OF A REDUCED HOLDING PERIOD

Percent Investing and Mean Amount of New Investment

If the capital gains holding period were reduced from one year to six months, would it cause you to make new investments, or increase existing investments in any of the items below?

(a) Common stocks
(b) Initial public offerings
(c) Real estate other than home
(d) Options
(e) Bonds (including corporate, government and municipals)
(f) Common stock mutual funds
(g) Tax shelters
(h) Rental property
(i) Futures
(j) Tangible investments
(k) Preferred stocks

Over half of the survey respondents—53%—indicated that they would either make new investments or increase existing investments in one or more of the 11 investment vehicles if the holding period were reduced to six months.

Nearly 4 in 10 survey respondents would make new investments or increase existing investments in common stocks of companies already traded, with the mean value of new/additional investments in seasoned equities amounting to $18,727.

Another 14% responded that they would make new investments or increase existing investments in initial public offerings (IPOs) of common stock. The mean value of new/additional investments in IPOs amounted to $10,480.

Real estate would also be an attractive vehicle for investors if the holding period were reduced to six months. Of the 11 investment alternatives listed, the mean amount invested by those who would respond to a shorter holding period was greatest in rental property and real estate other than home. In terms of the percentage of investors responding positively to a reduced holding period, real estate other than home was the third most popular investment vehicle following seasoned common stocks and initial public offerings.

Slightly less than 10% of the executives interviewed indicated either new investments or an increase in existing investments in bonds (corporate, government and municipal issues). The mean value of projected investments was $22,222, a larger mean investment in dollar terms than projected investments in either seasoned equity issues or IPOs. This larger figure may be attributable to the fact that most debt offerings are in denominations of at least $1,000, a considerably higher sum than the price of equity issues.

Only 3% of the sample would increase investments in tangible assets if the holding period were shortened. In terms of the percentage responding positively, tangible investments were trailed only by preferred stocks. Moreover, the mean additional amount projected for tangible investments—$6,250—was the smallest of all the investment vehicles listed.

These results indicate that a sizeable proportion of investors regard a one-year holding period as a deterrent to investment. In addition, the results suggest that the reduced risk brought about by a shorter holding period would stimulate a considerable amount of new investment.[3] Risk is now associated even with bond investment, reflecting the unprecedented volatility of the debt market in recent years in terms of interest rate movements and bond prices. Bonds are no longer considered an extremely safe and liquid investment, as bond values can undergo significant fluctuations in relatively short spans of time. Investors are concerned

[3]For some investors particularly interested in short-term investments, the lower tax rate for realizations in the six to twelve month time span would also be a consideration.

TABLE 1

EXECUTIVE REACTIONS TO A SIX-MONTH HOLDING PERIOD DURING THE FIRST YEAR

Total Executives: 53% would make new/increase investment

	Percentage of Executives Indicating Increased or New Investment	Average Amount to be Invested
Common stocks	39%	$18,727
Initial public offerings	14	10,480
Real estate other than home	13	68,277
Bonds (including corporate, government and municipals)	8	22,222
Rental property	5	83,417
Tangible investments	3	6,250

with these changes in value, especially if they might have to sell before the maturity date.

In a survey undertaken in October/November 1979, with respondents drawn from a similar executive pool, 48% indicated that they would make new investments or increase existing investments if the holding period were reduced to six months. The close correlation between the findings of these two surveys speaks well for the consistency of investor opinion, suggesting confidence in believing that investors would respond significantly and in a very positive manner if the holding period were reduced from twelve to six months.

Dollar Value of New Investment

The next question was asked only of those who responded positively to the reduced holding period:

By approximately how much would you make new or increased investments in any particular asset during the first year?

Of the 39% who indicated that they would add to their existing holdings or make new purchases of common stock of seasoned companies, 8% said they would commit less than $5,000; nearly 25% said that their investments would be between $5,000–$25,000, and 7% anticipated making investments of $25,000 or more during the first year after a reduction in the holding period to six months. The mean projected additional investment in seasoned common stock amounted to $18,725.

Among the 14% of executives that would increase existing investments or make new investments in IPOs, 5% estimated that their incremental investments would be less than $5,000; another 5% anticipated making additional investments of between $5,000–$10,000, and 4% thought that their investments would amount to $10,000 or more. The investment in new offerings is crucial to our economy for it is these newer, smaller companies that supply the most dynamic new technology, as well as the greatest proportionate number of new jobs.

Of the respondents who reacted positively to a reduction in the holding period by indicating investments in real estate other than home, over three-fourths stated that their investments would increase by at least $10,000. Of this group, over half would increase their investments by $25,000 or more.

With regard to rental property, another large proportion said they would increase their purchases significantly. Of the 5% who responded positively to a reduced holding period by acquiring rental property, 3% indicated new investments of $25,000 or more. Compared to all the investment vehicles listed, both real estate other than home and rental property had the largest means in terms of the additional money flowing to such assets.

About 8% of the executives surveyed intended to make new or additional investments in bonds if the holding period were shortened. Over 50% of these

executives estimated that their additional investments in bonds would be less than $10,000 in the year following a change in the holding period. Another 25% responded that their investments would increase between $10,000 and $25,000.

As noted earlier, only 3% of the sample responded positively to a reduction in the holding period by increasing their investments in tangible instruments. Of this group, all of the individuals stated they would increase their investments in tangibles by under $10,000.

Percentage Increase in Dollar Amount Invested

In percentage terms, a reduced holding period would attract significant new funds to common stock. Almost one-third of those who responded positively to a reduced holding period by increasing investments in common stock, would do so by increasing their investments 50% or more over what they otherwise would have invested. (See Table 3.) Another one-third of these investors would increase their investments in common stock by 20%–50%, and the last one-third would increase their investments in common stock by under 20%. From these indications, a reduced holding period could be expected to stimulate a significant amount of new investment in seasoned equities, thereby lowering the cost of sorely needed equity capital for U.S. companies.

For those investors attracted to initial public offerings, a significant amount of new money could flow to these investment vehicles. Of the 14% who responded positively to IPOs under a reduced holding period, almost 40% would increase their commitment by 50% or more. The remaining individuals were evenly distributed in increasing their commitment to IPOs under a 10%, 10%–20%, 20%–30%, and 30%–50% breakdown. (See Table 3.)

Summing up, the increased investment that would be generated by a six-month holding period represents substantial increments over what would be invested under the one-year holding period. Of those who would increase investment in one or more of the eleven investment vehicles, about 31% indicated that they would invest at least 50% or more than they would under the present holding period. In total, 66% estimated the incremental investment at over 20%, while the remaining one-third reported an increase of under 20% over what would have been invested. The data suggest that investment plans would be upscaled considerably if a six-month holding period took effect.

LOSSES DUE TO THE ONE-YEAR HOLDING PERIOD

During the past two years, have you experienced any cases where potential gains in investments, such as common stocks, that you owned and were planning to sell for long-term capital gains, either

TABLE 2

DOLLAR VALUE OF NEW OR INCREASED INVESTMENTS DURING THE FIRST YEAR FOLLOWING A REDUCTION IN THE HOLDING PERIOD BY TYPE OF INSTRUMENT

	Less than $5,000	$5,000-$9,999	$10,000-$24,999	$25,000 or more	Total**
Common stocks	8%	11%	13%	7%	39%
Initial public offerings	5	5	3	1	14
Real estate other than home	1	1	4	6	13
Options	4	3	2	1	10
Bonds (including corporate, government and municipals)	2	2	2	1	8
Rental property	1	1	1	3	5
Tangible investments	1	1	*	*	3

* Indicates less than 0.5%.
** Totals may not add up due to rounding.

TABLE 3

PERCENTAGE INCREASE IN AMOUNT INVESTED UNDER A SIX-MONTH HOLDING PERIOD

	Under 10%	10%-19%	20%-29%	30%-49%	50% or More	Total**
Common stocks	6%	7%	7%	6%	12%	39%
Initial public offerings	2	2	2	2	6	14
Real estate other than home	2	2	1	3	5	13
Options	2	1	2	2	3	10
Bonds (including corporate, government and municipals)	2	1	2	2	2	8
Rental property	1	*	1	*	1	5
Tangible investments	1	0	*	*	1	3

* Indicates less than 0.5%.
** Totals may not add up due to rounding.

shrank or turned into losses because of changing market conditions during the period between six months and one year of holding them?

Almost one-third—31%—of the executives interviewed indicated that potential gains from investments either shrank or turned into losses because of changing market conditions during the period between six months and one year of holding them.

Those executives reporting declines in value or a loss due to holding assets from six months to one year were asked the following question:

What was the total amount of capital gains you lost due to the one-year holding period requirement in the past two years?

As noted, 177 of the 568 executives (31%) indicated their potential gains had diminished or actually turned into losses because of the one-year holding period. Of these 177, 43% estimated that they had lost less than $5,000 over the past two years; 24% reported a decline in their holdings between $5,000–$10,000; 23% between $10,000–$25,000; 5% lost between $25,000–$50,000; and 4% reported a loss of $50,000 or more.

There is a positive correlation between the losses recorded and the income class of respondents, with those in the highest income brackets registering the largest losses. In general, higher income respondents have larger assets and investments in aggregate. As indicated in the table, 94% of the executives earning under $50,000 who reported declines or actual losses estimated the amount lost at under $10,000. These executives would represent the relatively new and younger investor, those more likely to assume the risk of investing in new and start-up companies in the hope of obtaining a large appreciation on investment.

Among the 31% who experienced a loss in potential gains because of the one-year holding period, the mean loss amounted to $15,714. Thus, the results of the survey suggest that one-third of all investors in the Executive Caravan lost about $15,700, on average, as a result of changing market conditions over the past two years because of the one-year holding period.

Impact on Tax Revenues

These losses have significant implications for Treasury revenues. If individuals have experienced diminishing gains or losses of potential gains because of retaining their assets for at least one year, the Treasury has obtained less revenue than if such individuals felt free to realize gains during a shorter time span. The average income of the executives in our survey who reported experiencing reduced gains or losses was about $70,000. If 10% of all returns filed in 1978 in the $50,000–$100,000 AGI class experienced a similar trend in capital gains, the total potential loss would be about $2.4 billion. Assuming the tax rate on capital gains for individuals in this income group in 1978 fell between 20%–25%, the estimated Treasury revenue loss ranges between $470–$590 million. This is in striking contrast to the $350 million "static" gain estimated by Treasury to be derived from lengthening the holding period from six months to one year.

TABLE 4

TOTAL AMOUNT OF CAPITAL GAINS LOST DUE TO THE ONE-YEAR HOLDING PERIOD RECORDED BY RESPONDENTS REGISTERING A DECLINE IN POTENTIAL GAINS

Total Executives: 31% had gains decline or actual losses due to the one-year holding period

Annual Income	Less Than $5,000	$5,000-$9,999	$10,000-$24,999	$25,000-$49,999	$50,000-$99,999	$100,000 or Over
Under $50,000	76%	18%	6%	0%	0%	0%
$50,000-$74,999	41	34	20	3	0	2
$75,000 or over	31	22	30	9	5	3
Total Respondents	43%	24%	23%	5%	2%	2%

Under a six-month holding period, investors could realize these capital gains before they diminish or turn to losses. The increased realization potential, we believe, more than offsets the estimated revenue loss due to taxing gains in the six-month to one-year time frame at capital gains rates rather than ordinary tax rates.

The lock-in effect of short-term gains has been explored elsewhere. In a recent paper, 1973 Treasury data on capital gains transactions were reviewed. The data show that investors have a marked inclination to put off short-term gain until these gains qualified for long-term tax treatment.[4] It was concluded that "the gross gain realized on all returns decreases monotonically for holding periods from under one month to five-six months, and then increases dramatically at six-seven and seven-eight months when, presumably, investors realize gains (now long-term) they have postponed realizing earlier."[5] It was during the "waiting period" that executives in our survey reported diminished gains or losses of potential gains because of changing market conditions.

IMPACT OF ELIMINATION OF THE HOLDING PERIOD

Percent Investing and Mean Amount of New Investment

As a means of fostering investment in the capital markets, there are many individuals who advocate that the holding period be eliminated entirely rather than reduced. To evaluate the impact on investors of the elimination of the holding period for tax treatment of capital gains, the following question was asked:

If the capital gains holding period were eliminated, would it cause you to make new investments, or increase existing investments in any of the 11 alternative investments listed earlier?

Well over half—57%—of the respondents indicated that they would make new or increase existing investments if the holding period were eliminated completely. This compares to 53% if the holding period were reduced to six months. Again, common stocks were the most favored investment, with 42% of the respondents saying they would increase investments or make new investments in common stock if the holding period were eliminated. The next investment vehicle in importance was IPOs, with 17% indicating investments in such issues. Real estate other than home, favored by 16%, followed. The percentage responding positively to this proposal and the mean amounts invested in several vehicles are highlighted in Table 5.

Basically, the responses to the complete elimination of the holding period are similar to those for a reduction in the holding period to six months. In almost all investment vehicles, the percentage of executives who responded favorably to the change in the holding period increased with elimination of the holding period, as compared to a reduction to six months. Only in the case of tangible investments did the percentage slip slightly, and even here it was insignificant. It may well be that a few individuals selected other investment vehicles instead of tangibles with the complete elimination of the holding period.

In most cases, the mean amount invested increased with the complete elimination of the holding period. Logically, those that responded favorably to a reduced holding period would be inclined to respond even

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[4] A six-month holding period was in effect in 1973.

[5] Steve Kaplan, *The Holding Period Distinction of the Capital Gains Tax*, National Bureau of Economic Research, Inc., Working Paper No. 762, 9/81.

more positively to a complete elimination of the holding period. However, in the case of real estate other than home and rental property, the mean amounts invested dropped materially. The increased number of individuals who responded positively to elimination of the holding period may have represented new investors in these investment vehicles who would not commit the same significant sums as those already familiar with such assets, thus driving down the averages. Overall, the results are consistent and indicate that, for the most part, a complete elimination of the holding period would attract even more investors and stimulate more investment than a reduction in the holding period.

Dollar Value of New Investment

Those responding positively to elimination of the holding period were asked:

Approximately how many dollars would you use to make new or increase existing investments in the 11 alternatives during the first year if the holding period were eliminated?

The additional sums that would flow to the various investment vehicles are indicated in Table 6. These sums are impressive in the case of common stock and initial public offerings. Almost 25% of those responding positively in common stock to elimination of the holding period would commit an additional $25,000 or more. More than 25% would commit from $10,000–$25,000 to this investment vehicle, while slightly less than 25% would commit from $5,000–$10,000 to common stocks. The mean common stock investment, given an elimination of the holding period, was $27,144, compared with $18,727 under a six-month holding period. Similarly, the mean investment in initial public offerings was larger under an elimination of the holding period, $12,213, than a reduction to six months, $10,480.

Particularly in the case of bonds, more investment would be generated by an elimination of the holding period. While the percentage of executives indicating new or additional investment in bonds is 8% under both proposals, executives indicated a $37,563 average commitment under the elimination proposal. The mean investment if the holding period were reduced to six months was $22,222. The holding period is clearly an important consideration, given the reluctance of investors to commit funds to the long-term debt markets in recent years.

Real estate other than home and rental property also appear to attract significant sums of money if the holding period were eliminated entirely. Half of those who responded positively to investing more funds in real estate other than home would commit $25,000 or more. In addition, more than half of those responding positively to rental property with the complete elimination of the holding period would commit $25,000 or more.

COMPARISON OF REDUCTION AND ELIMINATION OF HOLDING PERIOD

Based only on responses in this survey, the total new/increased investment generated by a reduction or elimination of the holding period is impressive. With a

TABLE 5

EXECUTIVE REACTIONS TO ELIMINATION OF THE HOLDING PERIOD DURING THE FIRST YEAR

Total Executives: 57% would make new increase investment

	Percentage of Executives Indicating Increased or New Investment	Average Amount to be Invested
Common stocks	42%	$27,144
Initial public offerings	17	12,213
Real estate other than home	16	60,588
Options	10	47,308
Bonds (including corporate, government and municipals)	8	37,563
Rental property	7	60,515
Tangible investments	2	13,393

TABLE 6

DOLLAR VALUE OF NEW OR INCREASED INVESTMENTS DURING THE FIRST YEAR FOLLOWING ELIMINATION OF THE HOLDING PERIOD

	Less than $5,000	$5,000-$9,999	$10,000-$24,999	$25,000 or more	Total**
Common stocks	7%	10%	12%	10%	42%***
Initial public offerings	6	5	4	3	17
Real estate other than home	2	2	4	8	16
Options	3	3	2	2	10
Bonds (including corporate, government and municipals)	1	2	2	2	8
Rental property	1	1	1	4	7
Tangible investments	1	1	*	*	2

* Indicates less than 0.5%.
** Totals may not add up due to rounding.
*** Includes 4% who said they don't know.

six-month holding period, new common stock investment during the first year came to a significant $4.1 million, second only to the $5.0 million of new funds flowing to real estate. Rental property drew the third largest flow of new funds, followed by options at $1.3 million.

Compared to a six-month holding period, an elimination of the holding period produced higher total investment in eight of the eleven investment vehicles. Common stock investment jumped 56% to become the most favored investment vehicle, with total potential new funds at $6.5 million. Real estate other than home fell to second place, with new investment under the elimination increasing minimally from the six-month total. Rental property also increased minimally. Initial public offerings benefitted notably under an elimination proposal, increasing over 40% from $833 thousand to $1.2 million.

Extrapolating to the Population

Assuming that 10% of the individuals filing tax returns in 1978 in the same income class ($50,000–$100,000) has similar investment responses as the executives indicating increased investment, the amount of new investment stimulated by a reduction or elimination of the holding period is quite material. During the first year of a reduction or elimination of the holding period, total investment would be just under $50 billion. The increased funds flowing to common stocks alone would be about $2.8 billion under a six-month holding period and almost $4.0 billion with an elimination. Initial public offerings would also benefit significantly, with new investment running just a shade below $2 billion.

While these aggregate flows seem staggering, in the context of total financial assets of households they are quite plausible. From 1979 to 1980, the total financial assets of households increased by $660 billion to $4.5 trillion. The estimated $50 billion of new or increased investment unleashed by changing the holding period represents about 7.5% of the annual increase in financial holdings by households from 1979–1980.

Responses by Income Class

An analysis by income class shows that the complete elimination of the holding period had a more pronounced favorable impact on executives in the $50,000 and under income categories than on those in the income categories above $50,000. Further refined, the largest jump in favorable responses occurred in the $30,000 and under income category, with 20% indicating new/increased investment if the holding period were reduced versus 30% if the holding period were eliminated. Those in this income bracket choosing common stocks for new commitments increased from 10% to 20% under elimination of the holding period. This represents the largest percentage increase in commitment in comparing the two proposals across all income groups. In addition, under a

six-month holding period, none of the executives in this income class chose initial public offerings as a vehicle for new/ increased commitment. However, the elimination of the holding period elicited a 10% favorable response to investment in initial public offerings for the income class under $30,000.

In comparing the favorable responses to a reduction and elimination of the holding period, the second group showing the largest percentage increase was the $40,000–$50,000 income category. Under an elimination, 51% of the executives indicated new/increased investment while 42% had done so under the six-month reduction. Again, common stocks and initial public offerings attracted the bulk of investors. Common stocks were chosen by 36% of those responding favorably compared with 27% under the reduction in the holding period. Similarly, 15% evidenced new/increased investment in initial public offerings, compared with 10%.

These income class comparisons suggest that investors in the under $50,000 income category are particularly responsive to changes in the holding period. They would be considerably more inclined to make new/increased investment than those in the upper income group if the holding period were eliminated.

Overall, results are consistent for both proposals and each asset category. The elimination of the holding period prompted a slightly higher favorable response. Consequently, the percentage of investors willing to increase or add to investment in most investment vehicles increased along with a higher mean investment.

CONCLUSION

The results of this study present strong evidence that most investors consider the one-year capital gains holding period a hindrance to investment. Moreover, the survey findings indicate that a considerable amount of new or additional investment would be unleashed by a reduction or elimination of the holding period. Based on the percentage of executives indicating new investment, common stocks and initial public offerings were the two most favored investment vehicles for this increased investment.

The results of this survey indicate that increased gains in the six-month to one-year time frame may well offset static estimates of loss from a lowered tax rate. Conservatively extrapolating from the $15,714 average loss reported by executives in our survey, the potential Treasury revenue loss from diminished or lost potential gains in one year could be estimated to range from $470–$590 million. In terms of the current budget deficit projections, the revenue raising possibility of a reduced holding period should be considered seriously.

Given the unprecedented volatility of the investment climate in recent years as well as the country's acknowledged need to foster capital investment, the economy can ill afford measures that hinder investment and economic growth. Based on only the executives in our survey, the total new/increased common stock investment generated during the first year of a six-month holding period would be an impressive $4.1 million. The total new investment produced is, in general, quite significant under the six month or elimination proposal. Overall, the case for a reduced or eliminated holding period as outlined in this survey merits careful attention.

Technical Appendix

Sample Design

Each ORC Executive Caravan sample is drawn from a universe comprised of top and middle management people selected from the 500 largest manufacturing companies, and each of the 50 largest banks, utilities, transportation, merchandising, life insurance, diversified financial, and unclassifiable companies.

Three main steps are involved in the selection of managers and executives for ORC Executive Caravan interviews.

1. **Selection of companies.** Probability procedures are used to select companies where interviews will be conducted. The selection is stratified by size of company and by broad industry groupings.

   In general, a company remains in the sample for two consecutive quarterly surveys, then drops out until its next turn for selection. However, the replacement of companies in the sample is planned on a rotating basis, so that in any one Caravan survey half of the companies are carried over from the previous quarter, and half of the companies are newly selected for the sample.

2. **Selection of plants and other specific company locations.** Selection of specific company facilities is the second step in the selection of managers and executives. In general, each company in the sample is represented by its headquarters location and one or more additional locations.

   The selection of specific locations is planned within the framework of the Opinion Research Corporation National Probability Sample, which includes approximately 360 counties and all key industrial concentrations.

3. **Selection of specific managers and executives.** This selection is made from name lists furnished by selected companies to ORC sample specifications.

Cooperation of companies and their provision of name lists in accordance with carefully drawn sample specifications provide breadth and depth of coverage not normally possible through conventional lists sources.

Interviewing

In advance of the field interviewing phase of the study, a letter is mailed to each executive selected for the study. Specially trained interviewers contact executives for interview appointments at a mutually convenient time.

[1] *First-line supervisors* are considered as those whose primary responsibility is to supervise directly the work of clerical and/or hourly production employees.

Definition of Top and Middle Management

"Top and middle management" includes:

(1) Corporate and divisional officers
(2) Executives, managers, and supervisory professional personnel above the level of first-line supervisors[1]
(3) Professional personnel who report directly to corporate or divisional officers
(4) Executives in staff functions (personnel, legal, etc.) who report directly to corporate or divisional officers

"Top and middle management" excludes:

(1) First-line supervisors
(2) Non-supervisory professional employees (engineers, chemists, lawyers, etc.) who do *not* report directly to corporate or divisional officers
(3) Employees in staff functions (personnel, public relations, research, etc.) who do *not* report directly to corporate or divisional officers
(4) All other employees not covered by items 1 through 4 above

Sample Characteristics, October 1981 ORC Executive Caravan Survey

The data in the table below present the characteristics of the Executive Caravan sample.

Age	
Under 40 years	27%
40–49	33
50 years or over	40
Education	
Less than college completed	10%
College completed	33
Graduate work	57
Geographic Region	
Northeast	44%
North Central	20
South	27
West	9
Management Level	
Officers	42%
Nonofficers reporting to officers	38
Managers reporting to nonofficers	20
Job Function	
Finance/accounting/control	17%
Manufacturing or production	9
Marketing	25

General management	16
Personnel	10
Engineering/research and development	8
All others	20
Kind of Company	
Manufacturing	69%
Nonmanufacturing	31
Length of Service	
Under 10 years with company	28%
10–19	37
20–29	21
30 years or over	14
Income	
Under $30,000	2%
$30,000–$39,999	11
$40,000–$49,999	19
$50,000–$74,999	35
$75,000 or over	33

Reliability of Survey Percentages

Results of any sample are subject to sampling variations. The magnitude of the variation is affected by a number of factors, including the number of interviews and the level of the percentages expressing the results.

The table below shows the possible sampling variation that applies to percentage results reported from the ORC Executive Caravan sample. The chances are approximately 95 in 100 that an ORC Executive Caravan survey result does not vary, plus or minus, by more than the indicated number of percentage points from the result that would be obtained if interviews had been conducted with all executives in the universe represented by the sample.

Size of Sample on Which ORC Executive Caravan Survey Result Is Based	Approximate Sampling Tolerances Applicable to Percentages at or Near These Levels		
	10% or 90%	30% or 70%	50%
600 interviews	3%	5%	5%
500 interviews	3%	5%	5%
400 interviews	4%	6%	6%
300 interviews	4%	6%	7%
200 interviews	5%	8%	9%
100 interviews	7%	11%	12%

Sampling Tolerances When Comparing Two Samples

Tolerances are also involved in the comparison of results from different parts of any one ORC Executive Caravan sample and in the comparison of results between two different ORC Executive Caravan samples. A difference, in other words, must be of at least a certain size to be considered statistically significant. The table below is a guide to the sampling tolerances applicable to such comparisons.

Size of Samples Compared	Differences Required for Significance at or Near These Percentage Levels[2]		
	10% or 90%	30% or 70%	50%
600 and 600	4%	6%	7%
600 and 500	4%	7%	7%
500 and 500	5%	7%	8%
500 and 400	5%	8%	8%
400 and 400	5%	8%	9%
400 and 300	6%	9%	9%
300 and 300	6%	9%	10%
300 and 200	7%	10%	11%
200 and 200	7%	11%	12%
200 and 100	9%	14%	15%
100 and 100	10%	16%	17%

[2] Based on 95 chances in 100.

Quality Control Measures

Quality control measures are applied in every phase of the ORC Executive Caravan survey.

Specialists in many fields are available for consultation with the Caravan survey director in the development of the questionnaire.

Interviewers are hired and trained, in person, to staff the probability sample, and their work is regularly checked for accuracy and validity.

Questionnaires are prepared for data processing by experienced coders, under the supervision of the survey director.

The processing of data is subject to rigorous internal checks designed to detect both machine and human error.

Chairman ROSTENKOWSKI. Mr. Stewart, you may proceed.

STATEMENT OF CHARLES W. STEWART, PRESIDENT, MACHINERY & ALLIED PRODUCTS INSTITUTE

Mr. STEWART. Good morning, sir.

Mr. Chairman, members of the committee, my name is Charles Stewart. I am president of the Machinery and Allied Products Institute, which represents the capital goods and allied product industries of this country. In a very understandable but brief time frame, I will only hit upon some high spots.

First, to make one point clear, because you are getting mixed signals from certain representatives of the business community on this subject: MAPI views the estimated deficits, whether you take the White House estimates or CBO's, or such experts as Rudy Penner of the American Enterprise Institute, we view the high deficits as totally unacceptable. Also, we are terribly concerned about the related problem of high interest rates.

We feel, unlike some administration spokesmen, that a further period of high deficits and high interest rates is not a price which we can afford to pay in connection with the ongoing thrust of the economic program. That does not mean, however, that we have any fundamental objection to the basic tenets of the Reagan program.

We believe an adjustment—what has been called by some a mid-course adjustment—can be made, perhaps in connection with the debt limit legislation; and that we can restore confidence, bring down interest rates, and build some integrity in our fiscal situation.

We suggest in our statement some approaches that might be taken, including addressing the entitlement programs, perhaps looking at excise tax increases, removing the absolute sanctity being given to the defense budget however important an increase in our defense is, and so on.

Our comments are largely addressed to five of the so-called "revenue enhancement" proposals. A word about that term. Really, it is a euphemism. It is nothing but a series of tax increase proposals and we ought to view them as such and then judge them on their merits.

We are especially concerned about two—the one relating to the completed contract method; and the one with respect to the proposed alternative minimum tax. We also raise some questions about whether or not the proposals relating to the industrial development bonds, speed-up of corporate tax payments, and withholding on interest and dividends might prove to be counterproductive. We suggest the committee take a look at those observations in that light.

We feel that the industrial development bonds do make a contribution, as the Governor of New York indicated, to our investment opportunities; and that certain streamlined procedures can be adopted to perhaps bring them into a more orderly means of administration. But they should not necessarily be abolished or crippled.

We feel that a further speedup in corporate tax payments, particularly after action taken in connection with ERTA, is overreach-

ing. Business does not have the genius capability of estimating tax liabilities down to the last gnat's eyebrow.

Withholding on interest and dividends is an old turkey that has been on the Treasury list for as long as I can remember. You have rejected it before. I urge you to reject it again.

Turning to the two areas in which we have a principal interest among the so-called "revenue enhancement" provisions: Completed contract method. This is a search, really, for revenue gathering without reference to the merits. It ignores the true character of long-term contracts, whether they are in the defense or nondefense area. The proposals would be damaging and counterproductive to capital flows and to capital investment.

These contracts require a significant period of time from inception to completion and acceptance, and typically entail high risk. Capital lost as a result of the proposal will have to be refinanced in the credit markets, often under terms and conditions that would be relatively disadvantageous. I see my time is running out. I will whip through the rest of this.

The proposed progress payment method, in brief, has little merit.

As to the minimum tax, this is unquestionably from the standpoint of tax policy the worst example that you can find of how not to make tax policy. What the minimum tax in essence does, whether you talk about the present law or the proposed change, is to cheat on provisions in the tax code which were adopted by this Congress or prior congresses for legitimate and very strong reasons to accomplish certain national and economic objectives.

It is an open invitation to manipulation by lengthening the list of tax preferences, changing the base, and tampering with the rate. Rather than changing the form of the minimum tax, we should repeal the present provisions in the law and not adopt an alternative.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF THE MACHINERY & ALLIED PRODUCTS INSTITUTE

SUMMARY

1. High deficits and interest rates.--MAPI does not view this hearing as one seeking comprehensive plans to deal with the estimated deficits over the next few years as alternatives to the program of the Reagan Administration. We, therefore, concentrate on certain so-called revenue enhancement recommendations (REMs) of the Administration.

   On the other hand, in its Introduction the MAPI testimony includes some observations on the deficit problem and how it might be addressed. The Institute considers the deficits as projected to be unacceptable. We feel that more action than the President has recommended is necessary in order to deal with the twin problems of high deficits and high interest rates. A bipartisan joint effort by the Executive and Legislative branches should be initiated. Further, it is our judgment that such additional action can be taken without reversing nor in the long run impeding the extraordinary array of new and sound economic directions established by the Reagan Administration.

   We do not see any conflict between our strong views about the deficits and the need to moderate them, and our comments on the revenue enhancement proposals.

2. Scope of our comments.--MAPI's recommendations on the suggested revenue enhancement provisions are limited to five proposals. Further, although we comment on five of these recommendations, we feel most strongly about two, namely, the suggested rescission of the completed-contract method of accounting for tax purposes and the newly formulated minimum tax recommendation.

   We also comment critically as to those REMs bearing on industrial development bonds, withholding on dividends and interest, and further speed-up of corporate tax payments. In these instances our purpose is to try to help ensure that the Congress in studying these three recommendations is aware of certain counterproductive results that will occur if the Congress conforms to Treasury views.

3. CCM accounting.--The Congress should reject outright the Treasury Department's request for repeal of completed-contract accounting.

   Completed-contract accounting should be retained as nearly intact as possible subject to reasonable rules of cost characterization as among "period" and "attributable" items and reasonable rules of severability and completion. The law should continue to reflect the principle that no tax will be due on a long-term contract until it is certain that taxable income--rather than a loss--is the result, whether or not advance or progress payments are received.

   The CCM proposals would be damaging and counterproductive. The revenues sought by the Treasury would be drawn from the cash flow of long-term contractors. Those contracts require a significant period of time from inception to completion and acceptance and typically entail high risk. Capital lost as a result of the proposal would have to be "refinanced" in the credit markets, often under terms and conditions that would be relatively disadvantageous.

4. Minimum tax.--The proposal for an alternative corporate minimum tax is almost as indefensible in principle as the existing corporate add-on minimum tax, and all such levies should be repealed. The minimum tax concept results in the negation or partial offset of tax preferences included in the Revenue Code for deliberate tax and public policy reasons. Congress should deal individually and directly with those "tax preferences" which seem to deserve review.

   MAPI has long held this position and documented its views in March 1977 in the pamphlet entitled "The Minimum Tax on Tax Preferences--The Back-Door Route to Federal Tax Increases" and in November 1980 in a commentary entitled "The Minimum Tax on Tax Incentives: A Threat to Capital Formation."

   An especially bothersome aspect of this proposal stems from our understanding that some 50 percent of the estimated revenue "take" would be due to the deferral of investment tax credits because no credits other than the foreign tax credit would be allowed to offset the minimum tax.

   The minimum tax lends itself to frequent manipulation by lengthening the list of tax preferences, changing the base, and tampering with the rate.

5. Industrial development bonds.--Tax-exempt financing for so-called "private" activities should not be eliminated, and depreciable assets financed with tax-exempt bonds should

not be relegated to straight-line depreciation. Also, for purposes of industrial development bond (IDB) financing, small-issue IDBs should be retained without any attempted distinction between "small" and "large" businesses.

MAPI does not object to certain suggested improvements in procedures relating to industrial development bonds.

6. Further speed-up in corporate tax payments.--The various proposals to speed up corporate tax payments would have the effect of requiring such taxpayers to overpay their liabilities in order to avoid penalties, and consequently should be rejected. The recommendation represents over-reaching on the part of the Treasury Department and it assumes a precise estimating ability which is impossible to achieve, even by large and sophisticated corporations.

7. Withholding on interest and dividends.--The proposal to have withholding of taxes on interest and dividends would burden unduly the financial affairs of many organizations and individuals (including the elderly), and should be abandoned. It probably would not be cost-efficient. In rejecting the proposal, the Congress should send the Treasury Department a message to delete the item for the foreseeable future rather than resurrecting it periodically.

STATEMENT

Introduction

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to comment to the House Committee on Ways and Means on tax proposals in the Administration's budget, as announced in President Reagan's State of the Union address on January 26, 1982, and amplified in his Budget Message of February 8, 1982. Since the outlines of the Administration plan were made known, Treasury has published further explanations of the tax initiatives, and we will comment on both general and specific aspects of the program.

Regarding MAPI's interest in this proceeding, the Institute represents the capital goods and allied product industries of the United States, and engages both in original economic research and public policy representation aimed at advancing the technology and furthering the economic progress of the nation. In this capacity, MAPI has a direct interest in the federal government's fiscal, monetary, and regulatory policies, which, in turn, have a substantial influence on the nation's prosperity and its progress toward goals of increased real growth, increased employment, an improved defense posture, and reduced inflation.

MAPI does not view this hearing as one seeking comprehensive plans to deal with the estimated deficits over the next few years as alternatives to the program of the Reagan Administration. We will, therefore, concentrate on the so-called revenue enhancement recommendations of the Administration. On the other hand, we feel obliged to make some observations on the deficit problem and how it might be addressed.

The Seriousness of the Projected Deficits

By any generally accepted measure, whether it be the Administration estimates or those of the Congressional Budget Office, even allowing for implementation of certain recommendations of the President, as to tax initiatives for example, this country confronts very high and serious deficits. MAPI considers them to be unacceptable at the levels projected. The Administration takes the position that even after application of as much discipline as possible to government spending, and even assuming the adoption of its tax initiatives, the remaining high deficits are the price that must be paid for continuing in effect the basic elements of the economic program which the President has advanced and which in large part the Congress has adopted.

MAPI has no quarrel with, indeed we applaud, the basic directions shaped by the President and his Administration in reference to reductions in tax burdens so as to increase equity and improve savings and investment; elimination of other government disincentives to savings and investment to the extent appropriate; reasonably accommodative but stable growth in the supply of money and credit; the elimination of wasteful and otherwise unnecessary governmental spending; and a reduction in regulation of the private sector to the extent consistent with the public interest.

On the other hand, although we strongly concur in these objectives and endorse their continued implementation, we feel that the deficit situation and the related problem of high interest rates, coupled with what we perceive to be some erosion of confidence in the state of the economy, require more action than the President has recommended in order to deal with the twin problems of high deficits and high interest rates.

Having made clear MAPI's general concurrence in what we consider to be an extraordinary array of new and sound economic directions established by the Reagan Administration, we feel that those directions need not be reversed nor in the long run impeded by taking some tax actions at this juncture, coupled with further expenditure reductions, which will contribute to a reduction in deficits at least in the coming years. As already indicated, it is not our purpose to lay out a definitive program to meet the objective just stated. That function, we feel, must be a joint effort by the Executive and Legislative branches. Our intent at this point is to underline our feeling that such a joint effort is necessary, indeed critical. A whole range of alternatives which have been discussed by members of the Congress and public commentators are certainly worthy of consideration.

Entitlement programs, in our view and as numerous members of Congress have pointed out, must be addressed. A possible freeze in domestic discretionary spending might be considered. Increases in certain excise taxes certainly are worthy of careful study. A significant number of members of the Congress have suggested that certain provisions of the Economic Recovery Tax Act of 1981 should be reexamined. If that were to take place, we would certainly urge that any reductions in benefits be evenhanded as between corporations and individuals./1 This prompts us to observe more generally our feeling that if a significant reduction in the deficit beyond the spending cuts already recommended by the President --and realistically some of those may not be adopted--is to be achieved, a program which will impact a range of interests is likely to be necessary.

Further, although we are very much aware of the need for the United States to strengthen its national security, as we confront the

1/ The legislative history of ERTA will show that MAPI was not only one of the strongest supporters for liberalized capital cost recovery allowances, but that we also urged that individual taxpayers be given substantial relief by across-the-board reductions in marginal tax rates.

overriding problems of high deficits and high interest rates, we do not believe that absolute protection can be given to the defense budget. Rather, at least some moderate and hopefully temporary reduction in planned defense expenditures should be considered. If approved, such a moderation should avoid unfavorable effect on improvement in maintenance and readiness.

Having said all this, let us return to the principal thrust of this presentation, the package of so-called revenue enhancement recommendations which the Administration has advanced and the Treasury Department has particularized. These recommendations are called revenue enhancement measures (REMs). This, of course, is a euphemism. For the most part they represent tax increases or have that effect. In this respect Administration rhetoric which opposes tax increases in general is inconsistent with the real nature of these proposals. As a matter of fact, tax increases are not only involved, the effects of certain of these recommendations are in conflict with the overall objectives of the Administration with reference to capital formation, savings and investment, etc.

At this juncture it is appropriate to reconcile our opposition to certain of these REMs with our strong views about the deficits and the need to moderate them. First, our views on the REMs are limited to five proposals so that by no means do we appear here in opposition to the entire package. Further, although we comment on five of these recommendations, we feel most strongly about two, namely, the suggested rescission of the completed-contract method of accounting for tax purposes and the newly formulated minimum tax recommendation. We also comment critically as to those REMs bearing on industrial development bonds, withholding on dividends and interest, and further speed-up of corporate tax payments. In these instances our purpose is to try to help ensure that the Congress in studying these three recommendations is aware of certain counterproductive results that will occur if the Congress conforms to Treasury views.

Finally, as we put in perspective our general comments about the deficits and high interest rates and our treatment of certain of the REMs now being considered by this Committee, we anticipate that the Congress will look at the tax proposals advanced by the Treasury Department as representing ideas for consideration in a broader effort to deal with the deficit-high interest rate dilemma. In other words, the REMs just represent one set of ideas which should be studied by the Congress as distinguished from being treated as a separable package of well-reasoned recommendations, which in many respects they are not.

Congress Should Reject Abolition of Completed-Contract Accounting Method and the Proposed Alternative Corporate Minimum Tax

CCM Accounting

The Treasury recommendations on completed-contract method accounting include a regulatory proposal and a legislative proposal which would repeal

the method. Reading between the lines, it seems fair to observe that the inclusion of a recommendation for statutory repeal at least infers a sense of weakness about the CCM accounting recommendations and a feeling that without a congressional repealer, Treasury would be swamped with law suits. Such litigation presumably would contest the legality of overturning long-established and well-reasoned regulations permitting completed-contract method accounting on a fair and equitable basis.

The CCM regulations under Code Section 451 would be amended to restrict severely the listing of indirect costs that will qualify as period items; and to "clarify" the rules on severability, aggregation, and "completion." Based on changes that would be made to regulations under Code Section 446, taxpayers using the accrual shipment or accrual acceptance method of accounting for multi-unit contracts would have to accrue income upon shipment or acceptance of the various units and not the final unit. Regulations implementing Code Section 471 would be amended so that taxpayers entitled to use an inventory method for a long-term contract also would be required to use the costing rules set forth for the CCM.

A legislative proposal would (1) repeal the CCM; and (2) provide that taxpayers must elect to use either the percentage-of-completion method or the "progress payment" method of accounting for long-term contracts. The latter method would be new and would have most costs be allocated to long-term contracts and be deferred until the taxpayer has a right to receive payment under a contract. When the right to payment accrues, the taxpayer could deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. Accrued payments in excess of costs would give rise to taxable income, and certain borrowings in lieu of payment would be treated as payments.

Generally, the proposals would be effective for taxable years beginning after December 31, 1982. However, taxpayers could continue to use the current long-term contract accounting rules for contracts entered into on or before February 26, 1982, and the existing period cost rules could be followed for such contracts by taxpayers electing the cut-off method of change in accounting. After 1982, period cost deductions allowable under the transition but not permissible in accordance with the new requirements would be an item of tax preference subject to the corporate alternative minimum tax.

In general.--MAPI strongly opposes the proposed legislation to repeal the CCM and to require the use of the percentage-of-completion or the progress payment method of accounting. Furthermore, as to the proposed regulations, we believe that completed-contract accounting should be kept as nearly intact as possible, consistent with reasonable rules of cost characterization, contract severability, contract aggregation, and "completion." The law should continue to reflect that it is inequitable to require the imposition of a tax on a long-term contract

before the taxpayer knows whether the contract has given rise to income or a loss. Further, the existence of advance or progress payments ordinarily has no bearing on this determination and, consequently, the accrual or receipt of such payments should not trigger income recognition. Finally, the minimum tax coverage of "excess period cost deductions" is inconsistent with our position on CCM costs generally and the minimum tax itself, and would amount to a "watering down" of the CCM transition rule for corporations that would be affected by the alternative minimum tax.

Consequences.--In MAPI's judgment, the CCM proposals would be damaging and counterproductive to contractors, as partially borne out by the Treasury's estimates of very sizable projected revenue gains to the government averaging some $4.0 billion per annum after the transition year. These revenues would be drawn from the cash flow of long-term contractors. They would be denied legitimate period cost deductions as incurred and would be taxed on accrued payments in excess of attributable costs regardless of the stage of contract completion and irrespective of uncertainties as to whether a transaction will be profitable or not. The tax policy implicit in the proposals is directly against the grain of policy that has been embedded in the federal income tax since 1918 and has not only "survived" periodic review but has been amplified, restated, and reaffirmed in deference to the circumstances of the long-term contractor to which it is addressed./1 Also, the proposal is at cross-currents with capital formation incentives of ERTA which would be more than offset in many instances by the CCM proposals.

Affected parties.--As to who would be affected, the answer is "long-term contractors" engaged in any eligible activity using the CCM or using inventory methods of accounting that are similar in their result. These are businesses with contracts that require a significant period of time from inception to completion and acceptance, and they typically entail high risk because of (1) the time to completion, and, in many cases, (2) "custom" or "state of the art" aspects of the contract subject matter./2 Among the risks that are greatly magnified in long-term contracting are those of supply interruptions, litigation, strikes, unforeseen changes in costs, inclement weather, delays of any kind beyond the control of the contractor, changes in technology or in applicable regulations and codes, adverse changes in credit availability and cost, change-orders initiated by the customer, and penalty clauses effectuated by events that were not anticipated.

1/ For a discussion by IRS of the reasons underlying the CCM, see Revenue Ruling 70-67, 1970-1 Cum. Bull. 117.

2/ MAPI's membership includes affected parties engaged in the manufacture and installation of many types of industrial and other machinery, including equipment that is custom-made; in construction; in advanced electronic systems for commercial applications; and in defense contracting.

Due to these types of risks along with customer retainages, the long-term contractor usually cannot know with any certainty the existence or magnitude of taxable income from a transaction until contract completion and customer acceptance.

Impacts.--In that connection, MAPI has engaged in some informal surveying to try to identify the potential impacts of the CCM proposals. The central concern of taxpayers is that some amount approaching or approximating the estimated provision for taxes payable upon contract completion (assuming profitable completion--which actually is not known at the time of estimation) would become due and payable in advance. Such an eventuality would siphon capital directly out of affected corporations and industries prematurely, and, even with a liberal transition rule could cause disruption and hardship. Almost universally, parties with whom we have spoken would have to "refinance" their lost capital in the credit markets, often under terms and conditions that would be relatively disadvantageous. Ultimately, they would hope to pass the increased costs to their customers in order to preserve acceptable profit margins and rates of return on invested capital, but their ability to do so and to compete in the future against companies not comparably burdened would be in doubt.

Having mentioned that ERTA benefits would be offset, we also note in the defense procurement context that efforts of the Department of Defense to improve the "climate" for contractors on matters of profitability and progress payments could be nullified by the CCM proposals. We think it unfortunate that companies engaged in high risk, high priority, low margin activities would be asked to pay taxes on their transactions before their taxable income therefrom, if any, could be ascertained. Our sentiments about this are reflected in excerpts from a February 25, 1982 letter of Frank C. Carlucci, Deputy Secretary of Defense, to R. T. ("Tim") McNamar, Deputy Secretary of the Treasury. Although Secretary Carlucci was not wholly critical and conceded that Treasury was the "lead" agency in establishing tax policy, he made the following deft observations:

> . . . [W]e are concerned about the impact these changes may have on the ability of contractors to finance the work they must perform under defense contracts. We are also concerned about the ability of the contractors to make investments in capital equipment that will result in more efficient production and thereby lower the total cost of our weapons systems.
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> * * *
>
> . . . The Economic Recovery Tax Act of 1981 did a great deal to provide investment incentives to the defense industry and was a move we strongly supported. We believe your current proposal will have the effect of removing those investment incentives and will put the

defense industry and other long-term contracting businesses at a productivity disadvantage in relation to other manufacturing firms. At a time when it is vital that defense productivity increase, we don't believe this change is wise.

Treasury's reasons for change.--Treasury's February 26, 1982 Release as it pertains to the reasons behind the CCM proposal is illuminating and deserves comment. First, the CCM is faulted for deferring tax recognition to a later date than is done under "standard [financial] accounting practices," a point that is virtually irrelevant in light of the tax policy that underlies the CCM but has no bearing whatsoever on financial accounting. Secondly, reference is made to "large and unintended tax benefits." In our opinion, the events of 1968-1976 surrounding the rearticulation of tax policy for advance payments and long-term contracts hardly could have yielded anything "unintended." This fact has been borne out by testimony of past Treasury officials who were directly involved in the most recent restatement of the CCM and full-absorption inventory costing regulations. Also, the reference to "tax benefits" is inapposite in the framework of a discussion of whether or not to discontinue nonrecognition of income where the existence of taxable income is not even known.

There follows in the same Release an expression of concern that, because of inflation and the increasing size of new contracts, the deductible costs often will exceed the income to be recognized from old contracts in any one year. This may be true in some instances, but it again is not germane to the issue, which is whether it would be sound policy to recognize and tax receipts or accruals on long-term contracts before the existence of profits can be determined. Nor does the same statement explain why deductions for period costs having no direct causal or beneficial relationship to particular contracts should be delayed until the completion of contracts to which they do not directly relate.

Disparities?--Treasury's explanation of its CCM proposals dwells at some length on presumed disparities as among companies that do and do not use the CCM. The computations are correct, given the facts and assumptions of the examples discussed, but the implication that there is an inequity is misleading. Specifically, taxpayers eligible to use the CCM ordinarily can use either the CCM, the percentage-of-completion method, or an inventory method of accounting, subject to rules of election, consistent application, etc. Each of these options has certain advantages and disadvantages, from both tax and financial accounting standpoints, and the taxpayer makes a conscious choice of accounting method based on individual preferences, exposures, and expectations. Indeed, we could present examples where a taxpayer using percentage-of-completion accounting would be better situated than one using the CCM. Treasury can create illustrations--such as those presented in its general explanation of the CCM proposals--for any scenario where there is a timing difference with respect to income and/or deductions, but the divergent results at the bottom line in a single case do not alone support an argument for tax revision.

The legislative proposal.--MAPI opposes the legislative proposal to repeal the CCM and require the use of percentage-of-completion accounting or the "progress payments" method. As noted later, we are willing to participate in the resolution of such matters as may need attention in the CCM regulations, but we very definitely disapprove repeal. In addition, we consider the progress payment proposal to be an unsatisfactory substitute for the CCM. As already noted, we do not believe that there should be any recognition of income and costs attributed to long-term contracts until completion where the taxpayer elects such treatment. In contrast, the progress payment method would treat the right to receive an advance or progress payment as being an event with tax significance calling for inclusion in income of the amounts in question offset by allocable costs that are current and previously unclaimed up to the amount of the accrued payment. Payments in excess of attributable costs would be taxed, but attributable costs in excess of payments would be carried forward. Advance payments would be spread over the 12-month period following receipt or accrual for purposes of inclusion in income or in some cases might be entitled to a longer spread upon request and with permission granted.

Little value.--Without wishing to seem intransigent, we find little redeeming value in the progress payment method (PPM). The PPM is a contrivance to augment and expedite the collection of revenues by the federal government, without apparent care for whether or not revenues ought to be gathered. Whereas the CCM since 1918 has allowed taxability to be determined on the basis of a time period equivalent to the contract's duration rather than the arbitrary, annual, accounting period, the PPM would scrap this option. The PPM would appear to be an unconstitutional tax on cash flow and capital itself rather than income; would have a "one way" aspect in that it would impose a tax where accruals exceed attributable costs but withhold recognition to the extent costs exceed accruals; and would interfere considerably with the financing of long-term contracts via loans, advances, and progress payments. An interrelated concern is that period costs would be severely restricted, a subject we will address for convenience in the context of the proposed regulations--see Appendix A to this statement--although they would be covered in the legislation as well.

Complexity.--Relatively little has been said to date about the complexity of the PPM, perhaps because taxpayers have been diverted by the extraordinarily high potential tax cost to them of the proposal. We readily acknowledge that enough accountants equipped with enough computers and calculators could master any system of books and records that is logical, symmetrical, consistent, and complete. By the same token, they would not select a system based on those characteristics alone, without reference to others already in place and such practical aspects as ease of implementation, simplicity of operation and maintenance, comprehensiveness of application, and universality of output. On the positive side of the ledger, we would commend Treasury for its intellectual curiosity in seeking to invent a new method of tax accounting, although we disagree that any new method is needed. On the negative side, we find the PPM to

be a peculiar "hybrid" with inconsistent, discontinuous links to at least four methods of accounting--cash, accrual, completed-contract, and percentage-of-completion--the net result of which is to tax work-in-progress based on cash and cost flows unrelated to earnings.

New systems.--A number of taxpayers that have examined the PPM closely and used it to "price out" the Treasury proposal for contracts with advance and progress payments spanning a number of years have remarked that the method is much more difficult to use than any one currently in place or previously available. Under the PPM, cash receipts or accruals virtually take on the significance of sales requiring new record keeping for such amounts and for current and previously unclaimed costs. Whereas the CCM is relatively simple to operate and seems understandable to people, the PPM would require fairly elaborate new accounting systems and procedures useful for no purpose but tax reporting, and is not reconcilable with established policy objectives. In deciding whether to act on the PPM or not, we feel that the Committee should inquire not only into the policy but also into the procedural aspects--although the latter admittedly are of less moment--because we understand that unnecessary paperwork burden imposed on the private sector by the government for special purpose reports is anathema to the current Administration and of some concern to the 97th Congress as well.

Contract-by-contract taxation?--One of the more unusual features of the PPM proposal, in our opinion, is Treasury's intention to determine on a contract-by-contract basis whether a taxpayer must recognize income for a particular year. Consequently, taxpayers would not be able to offset income from one contract with costs from another contract. If, for example (to use Treasury's illustration), a taxpayer had two contracts, Contract A and Contract B, and progress payments exceeded costs with respect to Contract A but not with respect to Contract B, the taxpayer would recognize income from Contract A, even if the excess costs from Contract B equaled or exceeded the income recognized from Contract A. We understand that Treasury also has reported informally to interested parties that income recognized in an early year of a contract generally could not be offset by reversals on the same contract in a subsequent year prior to contract completion.

As the Committee will recall, taxpayers currently may offset "gain" transactions and "loss" transactions in figuring their taxable income (or loss), and any move to contract-by-contract taxation--or even "product-line" taxation, by some definition--would complicate the system tremendously and completely disengage it from its traditional "mooring" of overall taxable income. Along those lines, we find it discouraging that Treasury would consider seriously a proposed method of accounting that could result in substantial tax payments by an enterprise actually in a loss position on a total-entity basis. As to the planned denial of "offsets" on individual, multiyear contracts--as compared to offsets among several contracts--the very idea amounts to "heads I win, tails you lose" with a vengeance. We urge the Committee to reject the PPM with all of its

ill-advised trimmings, including the one that would disallow offsets. In the unusual event that tax policy considerations alone do not ring the knell for the anti-offset concept in some minds, we would remind the Committee that the provisions once in effect for the renegotiation of government contracts after completion even allowed for the offsetting of gain and loss transactions.

Financial accounting and non sequiturs.--We wish to reemphasize one point on tax and financial accounting distinctions, because we are aware of some disposition on the part of Treasury to "substantiate" its proposal based on movements in the financial accounting arena to restrict the availability of completed-contract accounting. We refer to Statement of Position (SOP) No. 81-1 of the American Institute of Certified Public Accountants (AICPA) on "Accounting for Construction-type Contracts," and Statement No. 56 of the Financial Accounting Standards Board (FASB) establishing SOP No. 81-1 as "preferable" for changes in method of accounting under Accounting Principles Board (APB) Opinion No. 20. First, any "justification" sought by Treasury from SOP No. 81-1 on behalf of its tax proposal is not pertinent because the tax policy supporting the CCM for tax accounting purposes is not relevant in establishing financial accounting standards. We refer to the principle of withholding taxation until the existence of taxable income is known. The CCM always has been a departure from orthodox accrual accounting for this reason, and ostensibly "supporting" references to financial accounting conventions are not controlling.

Whence Section 462?--We remarked earlier that long-term contracts typically have more risk than other transactions. Rather than extract taxes during the course of performing a contract that ultimately may be a loss, the government, under CCM accounting, waits until the results are known. Now that Treasury proposes to abandon this established policy, we should call attention to the fact that the Internal Revenue Code still does not allow taxpayers to claim deductions for estimated future losses. MAPI and most other interested parties--including the accounting profession --sought this type of reform of the tax laws in 1954 to reflect proper accounting, and the erstwhile Code Section 462 was the result, only to be repealed shortly after enactment because the draftsmen failed to include appropriate safeguards and transitions. The matter was addressed again briefly in the early 1970s only to be shelved, a victim of budgetary priorities. Short of exhuming a complicated issue to add to others already "on the table," we would simply observe that repeal of the CCM would be inequitable in the absence of some other device to mitigate the burden of taxes where the risk of loss is substantial.

The regulatory proposal.--Detailed comments on the regulatory proposal, particularly with respect to costs that would be removed from the existing list of period items, are included in Appendix A to this statement.

Effective date and transition.--It seems obvious to MAPI that any adverse legislative or regulatory changes in the tax law affecting

long-term contractors--which changes we do not here support--should thoroughly exclude transactions entered into prior to a date at least six months following enactment and promulgation. Due to the lead time in bidding for such contracts and dramatic cash-flow effects that changes in the tax law and regulations could have, this type of delayed implementation strikes us as the only practical way to lead into a new tax framework without disruption. Furthermore, time would be needed to bring the new accounting "on stream" if only to accommodate systems and software changes, and personnel reorientation. Clearly, taxpayers can take no definitive steps until the policy is established, and there certainly is nothing talismanic or actionable about events that occurred on September 24, 1981 (the President's fall budget message) or February 26, 1982 (the issuance of explanations of the proposals). As with the question of costing, discussed earlier, fairness should be the criterion and not the flow of revenues to the government.

Minimum Tax

Effective January 1, 1983, the current add-on corporate minimum tax would be replaced with a new 15 percent alternative minimum tax on "corporate profits" in excess of $50,000, which would be paid if it exceeded the regular corporate minimum tax. Corporate profits would be calculated by adding back to a corporation's taxable income (excluding net operating loss carryovers or carrybacks) the following series of special deductions, which expand upon the items of tax preference subject to the current minimum tax:

1. Excess percentage depletion.
2. Accelerated depreciation on real property.
3. Amortization of certified pollution control facilities.
4. Amortization of child care facilities.
5. Reserves for losses on bad debts of financial institutions.
6. Intangible drilling costs.
7. Mining exploration and development costs.
8. Lessors' leasing benefits.
9. Deductions for debt to buy or carry tax-exempt securities.
10. Deferred DISC income.
11. Certain shipping income.

12. Amortization of motor carrier operating rights.

13. Excess interest on original issue discount bonds.

14. Deductions for certain costs incurred with respect to long-term contracts.

In general.--To reiterate our position generally, the corporate alternative minimum tax proposal--like the existing corporate add-on minimum tax--is indefensible in principle, and would be an administrative morass. Whereas the change from an add-on to an alternative minimum tax, considered in isolation, would be unobjectionable, the underlying concept of the minimum tax itself is gravely defective and the Administration's proposal would extend and seriously complicate the original policy error. We believe that the corporate and individual minimum taxes should be repealed, and that Congress should deal individually with such "tax preferences" as may seem to deserve review. MAPI has long held this position and documented its views in March 1977 in the pamphlet entitled "The Minimum Tax on Tax Preferences--The Back-Door Route to Federal Tax Increases" and in November 1980 in a commentary entitled "The Minimum Tax on Tax Incentives: A Threat to Capital Formation."

There is a broad spectrum of support for this basic proposition we espouse, including such noted authorities on taxation as Professor Boris I. Bittker of Yale University Law School who testified in pertinent part before this Committee on June 23, 1975, as follows:

> I want to address myself this morning, and I will do this briefly, to a fundamental question that I think your committee must cope with. That is whether in approaching your task you would do well to focus on tax provisions individually on their merits retaining those that seem worthy, repealing those for which a good case cannot be made, modifying, limiting, expanding, and so on, others as that seems appropriate; or whether instead the committee should continue along the tendency which has become evermore apparent in the last few years of moving to such roundabout, as I would see them, approaches to tax reform as the minimum tax, the proposed limit on artificial accounting losses, and the proposed allocation of permanent deductions between taxable and exempt income.
>
> I would like to urge the committee to do the former, to bite the bullet of tackling statutory provisions head on making the judgment and then standing by the judgment as to whether provisions considered on their merits are worthy, should be repealed, should be expanded, or modified, and so on.

First, a comment on the minimum tax which was enacted in 1969. In my view, this approach to the area is going to lead and indeed to some extent has already led to an open-ended endless process of tinkering with very little positive advantages, and some serious disadvantages.

You have already faced, and I am sure if you continue on this road, will face again and again in the future the question of whether a minimum tax should be an alternate tax to be paid instead of the regular tax under specified circumstance, or a supplemental tax, or auxiliary tax to be paid in addition to the regular tax.

You will have constantly before you questions of the exemption level for the minimum tax in whatever form it may be adopted. You will have the rate question. You will have above all an endless series of questions about the items to be included as tax preferences or tax allowances, or whatever the label may be, because it is perfectly clear to me, and I think clear to all that there are bound to be a series of distinctions or compromises between a wholly comprehensive concept of economic income which as has been suggested before would include net worth changes, and a singling out of particular items, particular tax provisions for inclusion in the economic income base.

In other words, economic income it seems to me is almost certain to be itself a series of compromises, and I think this committee will find the making of those compromises a never-ending process, and in the meantime it is my view that the basic provisions themselves will tend to be neglected on the theory that whatever defects they may have will be adequately taken care of through the minimum tax, and indeed there may be an invitation, an implicit invitation to expand the basic provisions in a way which miraculously Mr. Surrey and Mr. Smith agreed was undesirable on the theory that, no matter what you throw into the Code, the minimum tax will make up for the defects of that decision.

Then finally with respect to the minimum tax, it seems to me its fundamental concept is open to serious objection. What I mean is this: That if for some reason the committee and the Congress determined that a particular tax allowance, let us say, for low-cost housing, or whatever it may be, is desirable, I find it difficult to understand why one should then nibble around the edges with a minimum tax. If a particular housing project for example is to be encouraged, or housing is to be encouraged through this tax allowance that I have just suggested, why should it make a difference that "A" invests a great deal in that

project and helps to get it built and gets the deductions which are implicit in that project, or "X", "Y", and "Z", enter into the project as partners and divvy up the tax allowances among them in a way that escapes the minimum tax?

In other words, once your decision has been made to adopt the allowance because you see a social objective or an economic objective that is to be achieved, it seems to me that you ought to be prepared to accept the responsibility that that allowance is going to be availed of by persons who wish to invest or move into that activity and, as I say, I find it difficult to understand why assuming the objective is desirable it should make a difference that one person moves into it very heavily, or a group of people move into it on a more restrained scale./1

* * *

Understatement.--To describe the minimum tax as a "roundabout" approach to tax reform is to engage in understatement. The Congress enacted certain tax incentives because it found they were economically or socially desirable, and then it imposed a minimum tax on the incentive element to dampen its effect. This is policy in a state of confusion--a point to which we will return--and we are no more sanguine about the device after 13 years of exposure to it than we were in 1969 when it was enacted. Although an alternative minimum tax comports more nearly with the "fair share" rationale for the levy than does the add-on variety, the allegations of runaway overindulgence in tax preferences by wealthy taxpayers has not held up well under close scrutiny, and the tax never will prevent avoidance by those so inclined in any event. Meanwhile, it is an unwelcome complication of a federal income tax law that already is too complex, and, to aggravate matters, the tax undermines legislation that was enacted to reduce tax disincentives to capital formation. The minimum tax is "scattershot" policy with the appearance of an abdication of responsibility; it obfuscates legislative intent as to the handling of specific issues; and it, therefore, should be repealed.

Confusion.--Returning to "confusion" as it relates to the proposals, we can assure the Committee that the management and planning of corporate affairs is not facilitated by uncertainties with respect to tax burden. The minimum tax proposal would introduce a new element of uncertainty because corporate taxpayers--especially in capital-intensive, cyclical industries--often could not know with any degree of assurance whether and in what amount they would incur the alternative levy. Similarly, the possibility of encountering the minimum tax would always leave doubts as to the "benefit" to be expected from tax preferences otherwise

1/ "Tax Reform Hearings," June 23-25, 1975, Committee on Ways and Means, U.S. House of Representatives, 94th Congress, 1st Session, Committee Print, pp. 73-76.

routinely available to corporations in their operations. Whereas Treasury has given the impression that it wishes to tax corporations that pay little or no federal income tax while reporting large profits to their shareholders, the proposal bears no relation to income reported to shareholders and would affect many corporations with low, or nonexistent, regular, corporate income taxes even when there are book losses as well. This would be a strange--in some respects, ominous--turn of events, wherein minimum taxes would be extracted in years of difficulty (an untimely burden) and credited back against regular taxes payable in years of recovery (an untimely benefit).

Investment tax credit.--Another especially bothersome aspect of this proposal stems from our understanding that some 50 percent of the estimated revenue "take" from this proposal would be due to the deferral of investment tax credits (ITCs) because no credits other than the foreign tax credit would be allowed to offset the minimum tax. For example, consider a corporation "A" under existing corporate tax law with taxable income of $1 million: Assuming for simplicity a rate of 46 percent, the regular tax before credits would be $460,000. Assuming ample ITCs, up to 90 percent of the regular tax, or $414,000, would be offset by credits, leaving a tax payment of $46,000. Now hypothesize a corporation "B" under the proposed law with "corporate profits" in excess of $50,000 (i.e., the minimum tax base) amounting to $1 million, a 15 percent alternative minimum tax of $150,000 due and payable because (we will assume) it exceeds the regular tax; and sizable carryforward ITCs. This corporation "B" would have to defer its ITCs until a future year when the regular corporate income tax exceeds the minimum tax. Depending on the length of the deferral, the value of the ITCs could dwindle to nothing. MAPI objects to this "back door" attack on ITCs, and we cite it as but one of several shortcomings of a proposal that should be scrapped.

A minimum tax on no tax preferences?--We note also--from Examples 2 and 3 of Treasury's general explanation of the proposal--that the alternative minimum tax could apply to a corporation with none of the listed tax preferences. Consider corporation "A" in the previous example with $1 million of taxable income, $460,000 of tax before credits, $414,000 of credits, and a $46,000 regular tax payment under ordinary computations. This same company's "corporate profits" in excess of $50,000 would be $950,000 (i.e., $1 million of taxable income plus zero "special deductions" minus $50,000). The alternative minimum tax would be 15 percent of this amount or $142,500. Inasmuch as the alternative minimum tax would exceed the regular corporate income tax, the former would be due and payable, with a minimum tax credit of $96,500 ($142,500 minus $46,000) to be carried over as a credit against the regular tax in the next year's computation. This objectionable and unprecedented aspect of the proposal would resurrect the concept of "economic income," and saddle corporate taxpayers with a minimum tax of 15 percent on taxable income regardless of the circumstances.

Preferences.--As to the proposed new preferences, we note that a recent Congressional Budget Office (CBO) report identified the existence of some 104 categories of "tax expenditures" as being in existence for

fiscal year 1982./1 We assume that Treasury selected the new items in its list in order to curtail the cost of some preferences thought to be less efficient than others; to try to reduce controversial preferences; and/or simply to settle on ones with limited political exposure for the Administration. Short of traversing the entire list, we will direct our comments to deferred income of Domestic International Sales Corporations (DISC), with the intent that similar views could be addressed to most of the others. We stated earlier that tax incentives should not be reduced through the "back door" approach of a minimum tax but instead should be considered on their individual merits. DISC exemplifies this because the enactment or removal of an export tax incentive should be decided with reference to the international trade environment, including tax treaties, bilateral and multilateral trade pacts (where applicable), nontariff barriers to trade, and other U.S. and foreign export policy. The future of DISC benefits should not be a function of "fair share" rhetoric having nothing to do with the subject matter.

Summation.--To conclude on the minimum tax proposal, we see some usefulness to changing the corporate minimum tax--if there is not to be outright repeal--from an add-on mode that layers one tax indiscriminately atop of another to an alternative mode. However, we object to lengthening the list of preferences and having the tax operate where there is no preference income at all. Also, we urge the Committee not to allow any such tax to reduce the value of investment credits.

By any objective analysis, the minimum tax is a blunt, dull, mischievous, and just-plain-poor instrument of tax policy, and in our opinion, should be stricken from the statute books.

Reservations Expressed About Elimination of Tax-Exempt Financing for So-Called Private Activities (Industrial Development Bonds)

Treasury's proposal would limit tax exemption for "private purpose" obligations currently eligible under Code Section 103 to those issued under the following conditions:

1. The bonds must be approved by the highest elected official or legislative body of the governmental unit, or by a voter referendum.

2. For bonds issued after 1985, the governmental unit would have to make a commitment to the facility being financed equivalent to 1 percent of the face amount of the bonds on the date of issue, or designate the bonds as general obligations.

1/ "Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986," CBO, September 1981.

3. Depreciable assets financed with tax-exempt bonds would be subject to straight-line depreciation over the recovery period used for earnings and profits (E&P) computations.

4. Exempt "small issue" IDBs would be limited to "small businesses," as defined. A small business would be one with capital expenditures of less than $20 million over a six-year period and not more than $10 million of IDBs outstanding after issuance.

5. Within the restrictions of items (1) through (4) above, small-issue IDBs could be sold as a part of an umbrella issue of bonds.

6. Each bond would have to be in registered form and information concerning the issuance of the obligations would have to be reported by the state or local government to IRS.

7. Restrictions on the investment yield from the use of bond proceeds would be extended to reserve funds and funds held during the temporary construction period. Bond costs could not be taken into account in determining the arbitrage yield limitations.

8. Except as indicated above with respect to the financial commitment rule, item (2), the additional restrictions generally would apply to private purpose bonds issued after December 31, 1982. However, the restrictions would not apply to single-family mortgage subsidy bonds issued before January 1, 1984, because those bonds would be denied exempt status after 1983.

General observation.--As set forth earlier, we do not take exception at this time to the proposals for public approval; for a commitment by the sponsoring governmental unit; for registration and information reporting; or for increased arbitrage limitations--provided that each of the foregoing conforms to standards of fairness and administrability. We adopt this posture partly in response to Treasury's rhetorical characterization of IDBs as "private purpose" bonds. Although the bonds in question depend on the credit of private entities rather than that of governmental bodies, the federal income tax exemption for interest earned on such obligations has existed in the tax law since at least the early 1930s. The exemption is ascribable to the fact that state and local governmental units and previous Congresses have felt that "public" benefits are derived from facilities financed by IDBs, whether they are industrial plants attracted to areas deemed by state and local development authorities to need economic development or such facilities as convention halls, airports, sewage disposal plants, or pollution

control apparatus. We do not object to such further reasonable procedures as may be needed to ensure that municipalities consider IDB-financed facilities to have sufficient "public" interest to enjoy the benefits of exempt financing.

Conflicting objectives.--By the same token, we believe that if there are adequate safeguards of the "public" interest in so-called "private" facilities to be financed by IDBs, then it is senseless to superimpose on the IDB-financing process added requirements, such as straight-line depreciation over extended recovery periods, that drain off the benefits of exempt financing and render it an exercise in futility. Also, there is a curious and possibly irreconcilable conflict of objectives here because the Administration elsewhere proposes in its "new federalism" initiative to yield a portion of the federal tax base to the states in order to decentralize the responsibility for certain programs and, additionally, would establish "enterprise zones" with special federal income tax benefits--not unlike the practice of state and local development authorities in offering IDB financing for certain investments in selected areas. If decentralization of decision making and economic development through federal tax abatements are objectives of the Administration, then there would seem to be some merit in continuing to use a mechanism that has been in place for the last half century.

Unintended beneficiaries.--As to the criticism sometimes leveled at IDB-financing concerning occasional, infrequent "off beat" uses or unintended beneficiaries, we do not accept de facto repeal as an appropriate remedy any more than we would prescribe amputation to deal with a superficial wound. The newly proposed public clearance and commitment procedures would minimize these isolated occurrences, and we do not think that other constraints would be necessary or warranted. There has been some occasional discussion of restricting "small issue" IDBs to "industrial" development--from whence this form of financing takes its name--by some definition, as distinguished from "commercial" activity. As an organization mainly representing industrial enterprises, MAPI does not object in principle to this proposal. On the other hand, we could foresee difficulties in establishing and then administering such a distinction, and to do so would remove an element of choice from the decision on exempt financing that perhaps should be left at the local level. If the Committee nonetheless feels that new "small issue" IDB restrictions should be imposed, we would be less opposed to this definitional restraint than to the debilitating proposals for straight-line depreciation.

"Small" versus "large" companies.--Further concerning "small issue" IDBs, we strongly object to Treasury's proposed differentiation between "small" and "large" companies for purposes of eligibility. The federal income tax law should not discriminate in this way where there is no compelling policy rationale for treating similar situations differently. In asserting that large companies can finance their operations without resort to IDBs, Treasury seems to us to miss the point. The question is

not whether some category of companies can "afford" conventional--as compared to exempt--financing in an abstract sense. Rather, the question is whether a particular investment will or will not be made by any enterprise in a particular locality without the marginal reduction in anticipated costs derived from exempt financing. It stands to reason that more capital spending will be justifiable with exempt financing than otherwise--all other factors equal--and that projects considered uneconomic with conventional financing will not be undertaken by rational decision makers in any enterprise. The only practical effect of limiting "small issue" IDBs to "small" businesses would be to force the curtailment of some capital spending plans that normally would be approved.

Propriety of Further Speed-up in Corporate Tax Payments Is Questionable

Treasury's proposal to speed up corporate tax payments has three parts, as follows:

1. Required estimated tax payments would be increased from 80 percent to 90 percent of current year liability.

2. All remaining liability would have to be paid on the 15th day of the third month following the close of the tax year rather than half on the 15th day of the third month and half on the 15th day of the sixth month.

3. For large corporations (those with over $1 million of taxable income in any of the three preceding years) which base their estimated tax payments on the prior year income or liability, the minimum required payment would be 85 percent of current year liability in 1985 and 90 percent in 1986 and thereafter.

The first two proposals would be effective for tax years beginning after December 31, 1982. The third proposal would be effective for tax years beginning after December 31, 1984.

The float.--We do not feel that this speed-up of payments should be pursued because corporate taxpayers, like others, are unable to estimate their tax liabilities accurately prior to year-end and, even then, need the additional time currently allowed in which to gather information and carry out computations for that purpose. Also, the third proposal frankly strikes us as presumptuous in the wake of law enacted six months ago to raise the minimum percentage to 80 percent over a three-year transition period. We acknowledge that Treasury never will yield in its attempts to squeeze the "float" out of tax payments, but we also know--as, we suspect, does Treasury--that unrealistic requirements for the amount and timing of tax payments can only have the effect of compelling overpayment to avoid penalties. Treasury already is "stretching the fabric" more than it should

with its "cash management" initiatives, and we advise against any further undue pressure on taxpayers and withholding agents. In a nutshell, the Treasury Department has not made its case and the new proposal represents overreaching. It should be rejected.

Perspective.--To put our opposition in perspective, we should point out that most corporate tax payments come from entities that are multiestablishment, multidivision, multistate, and/or multinational enterprises. In organizations such as these--and perhaps even in "mom and pop" stores, although the circumstances would be different--uncertainties as to the total amount of current-year liability continue well beyond year-end, which accounts for the fact that remaining liability now can be paid in two installments and corporate returns often are filed with allowable extensions on the 15th day of the ninth month after year-end. We emphasize that there are few, if any, parallels that can be drawn between the circumstances of corporations such as these and individuals with respect to their abilities to estimate and pay tax liabilities promptly after the close of their annual fiscal periods. Also, Treasury's assertion that corporations can estimate their income "on a monthly basis" --impliedly with accuracy--simply is misleading.

Some facts.--It is not true that corporations can estimate their taxable income with accuracy on a monthly basis, and any reference to book income in this context is not germane. Estimated tax payments are based on a host of projections backed by a myriad of assumptions, and they are particularly uncertain early in the year. Even as the year progresses, changes in capital spending plans, fixed asset dispositions, and other departures from earlier projections can alter the outlook as it relates to final tax liability. Let us add that management changes-of-direction having a direct bearing on tax liability for the year are often made without any reference at all to the tax incidents. Contrary to Treasury's assertion, for many corporations the "remaining payments" on March 15 and June 15 (assuming calendar year companies) are educated guesses because of organizational complexity, geographical diversity, and the mechanics of assembling data and preparing returns.

Other considerations.--We urge the Committee to recognize that a corporation, especially a multiestablishment one with international operations, needs time to compute its tax liability accurately. This also helps to minimize problems arising on audit, hopefully a benefit to IRS as well as the corporate taxpayer. It may be of some interest to the Committee members to know that tax management personnel of corporations often personally visit major reporting locations after year-end to review planned submissions and try to avert errors that otherwise would require extra attention on audit at a later date. Clearly, the time frame cannot fairly be compressed in the way that Treasury has proposed.

Finally, Treasury indulges in excess when it proposes still higher percentages for estimated taxes based on the prior year's liability.

Had Congress wished to make such a change when it enacted ERTA six months ago and boosted the number to 80 percent, Congress would have done so at that time.

To conclude on this subject, we have been advised by some of our member companies that the cash management changes alone could negate all of the cash flow benefits they derived from ERTA.

Congress Should Reject Treasury Recommendations on Interest and Dividend Withholding

As outlined by Treasury, a flat rate tax of 5 percent would be withheld from interest and dividend payments made to individuals in generally the same manner that tax currently is withheld on wages. Corporations and nontaxable individuals filing exemption certificates would be exempt from withholding. Taxpayers age 65 or older with tax liability of $500 ($1,000 on a joint return) or less also would be exempt from withholding. The proposal covers all payments of taxable dividends and interest that now are subject to information reporting, as well as payments on other obligations of a type generally offered to the public. Interest paid by individuals would not be subject to withholding. The proposal would extend withholding to include payments without a threshold dollar amount. Payees would attach copies of revised Forms 1099 showing income and withheld amounts to their tax returns, and they could adjust estimated tax payments and wage withholding to avoid over-withholding.

Individuals would not be allowed partial exemptions from withholding for the $100/$200 dividend exclusion, or for the 15 percent net interest exclusion effective after 1984. However, no withholding would be required on interest paid on All Saver's Certificates, dividends reinvested in public utilities' stock pursuant to a qualified Dividend Reinvestment Plan, or interest paid on tax-exempt state and local bonds.

Opposition.--MAPI considers this proposal to be the most thoroughly shopworn item in Treasury's inventory of proposed tax revisions. Although interest was made subject to withholding--along with certain other kinds of income not including dividends--by the Tariff Act of 1913, all withholding other than for some payments to foreign recipients was repealed in 1917 in favor of information reporting and not reinstated for wages until the Revenue Act of 1942 and Current Tax Payment Act of 1943. Thereafter, the subject of withholding on dividends and interest has arisen with enough frequency to fill the public record with very substantial evidence in opposition. The Committee will recognize that this opposition is not offered without realization that there is some "leakage" in tax collection from dividends and interest. Nor, we might add, do the opposing parties always represent types of payors who would be unduly burdened by the proposals. The "flaw" in the idea is that the total estimated costs do not seem to have a reasonable relationship to the anticipated benefits.

Costs and benefits.--In referring to the total costs, we include the paperwork burden of payors and taxpayers (including the elderly); reduced cash flow to dividend and interest recipients, depending on the design and use of exemption procedures; complications associated with the withholding exemption procedures; questions of definition and coverage as to dividends and interest; new regulations to cover withholding procedures for many differing types of payors and financial instruments; identifying and segregating "covered" versus exempt persons; the failure or inability to take account of the dividend or net interest exclusions; and perhaps others. We cannot see that it would be useful to complicate the tax law and the affairs of so many parties for the sake of gaining a better timing of revenue flows to the government and a moderately improved compliance experience. If the current information reporting is not as comprehensive as Treasury would like, then perhaps it should be expanded. Indeed, IRS has stated publicly that the information reporting program is increasingly successful, and is achieving ever-higher percentages of successful document-matching. We still believe that this is the least-obtrusive approach to dealing with the taxation of interest and dividends.

In connection with the choice between extension of mandatory withholding and improvement in the information reporting system, attention should be called to the proposed bill, "Taxpayer Compliance Improvement Act of 1982" (S. 2198), introduced by Senate Finance Committee Chairman Dole.

Taxpayer burden.--Whenever government raises this subject, it extols the fairness of its proposal because of exemption procedures, including proposed allowable adjustments to withholding exemption certificates. At the same time, government surmises that such revenues as it may be losing may be largely attributable to inadvertence on the part of low-income taxpayers who cannot economically be pursued by IRS on audit. We do not know whether this is the case or not, but marginal taxpayers receiving interest and dividend payments would seem to us to be the ones for whom exemptions would be most necessary. Yet low-income individuals--including the elderly--are the persons most oppressed by the complexities of the existing tax apparatus, and they would find the exemption procedures difficult to use. In imposing withholding, Congress would, in our opinion, put many persons who would qualify for exemption in a position of overpaying their taxes, because they could not or simply would not avail themselves of the exemption arrangement. Just as government finds it cost-ineffective to pursue small accounts, so too would payors and many marginal taxpayers find it onerous to live with these new procedures.

Information reporting.--Inasmuch as the Committee will be hearing much more about this from payors and dividend and interest recipients, we will conclude our remarks by recommending that the withholding proposal be dropped. It is an idea whose time has not come, and information reporting still is the way to go.

* * *

MAPI takes no position at this time on other proposed tax revisions of the Administration, including such matters as modified coinsurance; increases in Internal Revenue Service (IRS) personnel; enterprise zones; user taxes; passport and visa fees; changes in the railroad retirement system; the highway trust fund taxes; hospital insurance taxes for federal civilian employees; and the "new federalism" proposal.

The Institute appreciates having the opportunity to appear before the distinguished House Committee on Ways and Means to present views with respect to the tax proposals in the Administration's budget.

95-127 O—82——29

APPENDIX A

MAPI Statement to the
House Committee on Ways and Means
April 1, 1982

Detailed Comments on the Regulatory Proposal Affecting
Completed-Contract Method Accounting

Treasury is of the view that more indirect costs, now allowed under Regs. 1.451-3(d)(iii) to be treated as period items deductible when incurred, should instead be attributed to contracts and matched against income at the time of contract completion. The proposed cost requirements would be the same for long-term contracts whether accounted for by the CCM, an inventory method, or the PPM. The costs that would be removed from the existing list of period items appear to be the following:

1. Marketing, selling, and advertising expenses that bear some undefined relationship to contracts.

2. Bidding expenses incurred in the solicitation of contracts awarded to the taxpayer.

3. "Other distribution expenses."

4. Interest.

5. General and administrative (G&A) expenses attributable to the performance of services that benefit the long-term contractor's activities as a whole.

6. Research and experimental (R&E) expenses that are directly attributable to particular contracts in existence at the time such expenses are incurred or incurred under any agreement to perform such R&E.

7. Percentage depletion in excess of cost depletion.

8. Depreciation and amortization (other than for idle equipment and facilities) reported for federal income tax purposes in excess of that reported for financial purposes.

9. Pension and profit-sharing contributions representing current service costs otherwise deductible under Section 404, and other employee benefits incurred on behalf of labor.

10. Costs attributable to rework labor, scrap, and spoilage.

11. Compensation paid to officers attributable to the performance of services which benefit the long-term contractor's activities as a whole.

Tampering.--Treasury would tamper here with most period costs allowed by the existing regulations, and reduce the list of eligible items in a manner that is arbitrary. Evidently, the government has been attracted to a concept of "full absorption" wherein almost every expenditure of an enterprise is allocated to a contract or product whether accounting conventions exist to support delayed cost recognition or not. We sense that Treasury is following a "rule of convenience" under which accounting orthodoxy is cited where it conforms to a preconceived notion about revenue collection but is eschewed where it is not conducive to the desired result. We have critical comments with respect to several of the cost categories that Treasury would attribute to contracts, because we do not agree that they were classified improperly by Treasury Decision 7397 of January 14, 1976. For present purposes, we will mention only several of the cost classifications, inasmuch as we oppose the PPM legislation generally and expect to have the opportunity to comment at length on the same matter in the regulatory proceeding.

Marketing.--First, we anticipate that there would be increased administrative burden and endless disagreement in deciding whether marketing, selling, and advertising expenses are attributable to particular contracts. For example, marketing personnel incur costs constantly, often without knowing whether, when, or to what extent their efforts will yield contracts of any duration, long-term or short-term, and the cost accounting systems of enterprises normally do not make such discriminations. Because of the nature and purpose of these and many other indirect costs, reasonable minds would disagree on the questions of amount and attribution. Along the same lines, most companies do not now treat any of these amounts as contract or product costs, and a number frankly have described the proposed reclassifications as "unworkable." As to bidding expenses, large expenditures can be made in this area over a span of months or years with no reason to know at the time of cost incurrence whether a contract will result or not. We question the propriety of delaying recognition as to any of these amounts until contract award. Also, because of the uncertainty that they will ever give rise to income, we believe that all such costs should be deductible as incurred.

G&A.--Concerning G&A that benefits all activities, including officers' compensation, the absence of a direct causal or beneficial relationship is the very reason why period costing should be permitted. One may argue that nearly every cost has some relationship--however tenuous--to a contract, product, or service, but proper accounting does not contemplate a delayed recognition of overhead expenses incurred for the business as a whole. Contrary to Treasury's proposal, there is a point beyond which "fuller" cost absorption in inventories or contracts is poor accounting for tax as well as financial purposes and does not yield a clear reflection of income pursuant to Code Section 446. We

doubt that financial reports prepared in accordance with the proposals would be approved by independent accountants because of the heavy indirect cost deferrals, and the accountants' judgment regarding "clear reflection" on this score would be no less appropriate for tax than for financial purposes. Sound accounting is not a function of how quickly the government collects revenues.

Interest.--To continue, "interest" is a cost of financing, and has been acknowledged to be a period cost for almost as long as double-entry bookkeeping has existed. Efforts to trace the cost to a cost objective, in view of the fungibility of money, are likely to be awkward or arbitrary, and there are few instances where capitalization of interest has been ruled appropriate or tracing has been attempted. One of these instances is FASB Statement No. 34, which has attracted criticism from many industrial accountants who think it preferable to expense all interest for financial as well as tax accounting purposes. Another aberration would be the provisions of Regs. 1.861-8--also controversial--which attempt to allocate and apportion certain U.S.-source interest against foreign-source income for foreign tax credit limitation purposes. The Committee also will recall that Code Section 163 treats interest as a deduction, and may wish to consider whether a contract-attribution approach to interest would compromise that policy. Finally, we would point out that interest on operating capital is not an allowable expense for cost reimbursement in defense procurement, and that delayed tax recognition would aggravate this inequity.

R&E.--As previously described, Treasury's proposal would treat as contract costs R&E expenses that are directly attributable to particular contracts in existence at the time such expenses are incurred or incurred under any agreement to perform such R&E. Other R&E could be deducted as a period item. From a cost-accounting vantage point, we have no serious "conceptual" difficulty with this because Treasury would require a tracing of R&E to cost objectives where that can be done, and evidently would not pursue the matter where tracing is infeasible. There are, however, two countervailing considerations, one related to national policy and the other a question of tax administration.

As to the former, Congress long has allowed the expensing of R&E under Code Section 174, and part of the rationale for this has been to preclude having the federal income tax system operate as a disincentive to R&E. The importance of having a favorable tax treatment for research spending is acknowledged in virtually all industrial countries' tax systems, and the incremental R&E credit enacted last year as part of ERTA is still another manifestation of U.S. policy in that regard. Under the circumstances, appropriate weight should be given in the decision on R&E costing to the policy conflict implicit in Treasury's proposal, and we definitely are inclined for this reason to favor the retention of period costing. Along the same lines, MAPI urged Treasury in the years 1973-1976 not to adopt regulations that would allocate and apportion U.S.-performed R&E to foreign-source income for foreign tax credit limitation purposes, because of potentially harmful, repressive effects on domestic R&E activity. Treasury largely ignored industry's admonitions about this, and the outcome

is that Congress--as part of ERTA--imposed a two-year moratorium on such costing pending a study to survey the "damage" and come up with recommendations. We are not anxious to have a "repeat" of the same experience in another R&E context.

The procedural consideration alluded to is that tax administration involving R&E, as proposed, would be problematic because of difficulties with definitions and the tracing of costs to cost objectives, such as contracts or products. Most R&E work is not performed by white-gowned individuals in laboratories, and identifying particular R&E costs and then associating them with contracts that have been benefitted or specific income that has been generated could be very much a matter of opinion. This practical consideration is another of the reasons for the treatment accorded R&E by Code Section 174, and we might add that the difficulty of tracing is the paramount purpose behind the long-standing rule generally requiring period costing for R&E in financial accounting. Treasury should study the public record of the Financial Accounting Standards Board relating to Statement No. 2, issued nearly ten years ago, because it documents at length the sort of difficulty that IRS would face in administering the regulation as Treasury has proposed it.

Depreciation.--Without covering each of the costs that would be shifted by Treasury, we will conclude for now on depreciation and amortization reported for tax purposes that is in excess of such amounts per books. In attributing this amount to a long-term contract and delaying recognition, Treasury would nullify to an extent the tax benefits just conferred by Congress in the Accelerated Cost Recovery System (ACRS). This type of equivocation and contradiction in tax policy is disturbing and reinforces the conclusion sometimes drawn in the private sector that federal income tax policy--including so-called "incentives" given with one hand and taken away by the other--are too unreliable to incorporate in decision making. We disagree with the Treasury proposal and deal with this same subject in connection with the corporate alternative minimum tax.

Change-orders.--Moving to other regulatory proposals, we note that Regs. 1.451-3(e) would be amended in several ways, one of which would specify that if an agreement is amended (as by the exercise of an option or the issuance of a "change order") to increase the number of items to be supplied under the agreement, such modifications shall be treated as a separate contract or as several separate contracts. As indicated earlier, we have no quarrel with reasonable rules of "severability" and "completion," and feel that the question should be settled by such regulatory amendment as may be warranted toward that end. Although we were unaware of flaws in the existing rules, we agree that contracts should not remain "open" indefinitely. As to the proposal just mentioned, options-to-extend and change-orders are quite different because the latter can significantly alter the economics of transactions, with the result that severability requirements in that context should not be rigid. Also, we do not agree that a contract should be considered "complete" without regard to any obligation of the contractor to supervise installation or assembly if final acceptance is dependent upon such actions and demonstrations of performance in accordance with specifications.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Chairman, I have just one blanket question for the entire panel. We appreciate your coming, and I do not want to put any of you on the spot, but are there any of the revenue enhancers that the President has suggested that you all favor?

Mr. BROPHY. If I could answer, Congressman Gibbons, I believe the user taxes are surely appropriate. Last September the President did urge looking at excise taxes. I believe there are opportunities there for further examination, also.

Mr. GIBBONS. Thank you very much.

Mr. O'BRIEN. I would add, Mr. Gibbons, that although it is not proposed at this time, I would re-emphasize the position which we took in our statement with respect to the reduction of the holding period. We truly believe that it will enhance revenues to a very substantial degree. It worked the last time, and we think it will work, and is something we should give serious consideration to.

Mr. GIBBONS. Thank you.

Mr. STEWART. We would not enter objections to those recommendations other than the five to which we took exception.

Mr. GIBBONS. Thank you.

Mr. BALDWIN. I would go along with that. I also gave you what we would support in my testimony.

Mr. PICKLE. I think it would be interesting—would you yield, Mr. Gibbons?

Mr. GIBBONS. Certainly.

Mr. PICKLE. I appreciate the testimony that you have given, because you have said we would need some midcourse corrections—we should defer the individual tax reduction, cut some in defense—and I think that is a positive position that some might be taking. But along the line of Mr. Gibbons' questions, let us just have a little trial run here, if you do not mind, to help me. Would you support elimination of completed contract accounting?

[No response.]

Mr. PICKLE. Would any of you support the repeal of energy tax credits for business?

[No response.]

Mr. PICKLE. Would any of you support the measure dealing with tax exempt revenue bonds for private activities?

[No response.]

Mr. PICKLE. What about the construction period interest and taxes proposal? Would you support that?

Mr. BALDWIN. As I said in my testimony, we would in certain situations.

Mr. PICKLE. All right. We have a qualified "yes" on that one. What about the minimum corporate tax? Do any of you support the minimum corporate tax change the President recommended?

Mr. BROPHY. I think we are all opposed to that in its present form.

Mr. PICKLE. Do any of you support accelerated corporate tax payments?

Mr. BALDWIN. We would support——

Mr. PICKLE. Do any of you support withholding interest and dividends, that "turkey" that was referred to?

Mr. O'BRIEN. I believe we have testified on that, Mr. Pickle.

Mr. PICKLE. Those are the major proposals. It seems to me that while you take a positive attitude, you think we ought to raise some revenue through excise taxes, consumer approaches. Now I am interested. I notice deregulation of natural gas was mentioned by Mr. Brophy, I believe.

Mr. BROPHY. That is correct.

Mr. PICKLE. Does that mean you would put a tax on windfall profits?

Mr. BROPHY. The position of the Roundtable is that deregulation itself would raise substantial revenue. I think it would be the decision of the Congress whether politically deregulation can take place without imposing some kind of a severance tax.

Mr. PICKLE. You would be for a severance tax?

Mr. BROPHY. That is not the official position of the Roundtable, no, sir. We have not taken a position on that.

Mr. PICKLE. By "excise taxes," you mean gasoline tax? Is that correct?

Mr. BROPHY. I think that fuel taxes would be one of the excise taxes that would have to be considered.

Mr. PICKLE. You say we have a serious economic problem because we have a lack of income, we do not have enough coming back into the Treasury, we have extreme deficits, and we must make some corrections.

And you want us to cut more spending, and I personally think that we should try to; but when we come to the question of raising revenue, you say: "Yes, do it." But you want somebody else to absorb the brunt of it.

The President recommended nine measures, and I have not gotten a strong "yes" on any one of them. So you see, you want to help, but you want somebody else to do it. Is that correct?

Mr. BROPHY. No, I do not think so, Mr. Congressman. I think that we have said that first of all the major effort has to be on cutting spending. When that has been done and has been done effectively, then we have to look at what is still necessary in order to get the deficit on a strong downward trajectory that has credibility. Without knowing what you can succeed in doing in cutting spending, it is hard to put a figure on what you have to raise in revenue.

But I think if you accomplish the first, then you can look at the revenue side and look at the various options. That is why we said that as a last resort a stretchout of the third year of individual tax cuts should be considered.

Mr. PICKLE. Well, I noticed that and I appreciate that. The fact is, though, and the point I am trying to make, as we try to solve the problems that we are all generally in agreement with, and most of you panelists have so testified, that we just simply cannot rule out any one aspect of it. You are for making these changes but you do not want to raise any revenue except through the excise taxes. Now, that exacerbates our problem up here.

Mr. BROPHY. I think I mentioned user taxes also. I think there are maybe other opportunties, but as you look at what happened under ERTA last time, the business community received the smallest proportion of the tax cut that they have received in any tax bill since the 1960's.

The proposals in the current budget, as I think the NAM testified recently, would take away well over 40 percent of the business cuts that were given to business last year in ERTA. And as far as corporations are concerned, it would take away only 60 percent of the first 3-year tax cuts.

So there is a very small base that you can deal with there without having a substantial adverse impact on the business community and the economy.

Mr. PICKLE. I thank you, Mr. Brophy, and thank you, Mr. Gibbons, for yielding.

Mr. O'BRIEN. May I comment on that? There are times, it seems to me, when the emphasis should perhaps be on increasing revenues, and there are times perhaps when the emphasis should be on the reduction of some of the expenses. I would suggest that this is perhaps a time when the emphasis has to be on the reduction of the expenses.

One needs only to look at what happened in the last several years with respect to those expenses to understand that. There are ways in which revenues can perhaps be raised. As a matter of fact, one was mentioned here this morning, the import oil tax. It is possible that something like that could be favorably considered at this time.

I would also want to state my own point of view with respect to the third year of the tax cut. I firmly believe that it should not be turned back at all, that it should be left in place. If that tax cut in 1983 is eliminated or reduced or stretched out in any way, I think what it will do is it will hurt the very individuals who were to gain the most, the individual taxpayer in this country.

Furthermore, I think what it will do, even though it is 1983, it can unfavorably impact coming out of this recession, which we believe is the case within the next coming months, the next several months, anyway, and furthermore, it can eliminate confidence for the future. So I most emphatically state that position.

Mr. STEWART. Mr. Chairman, may I say a word about Congressman Pickle's question. The thrust of your question is a very reasonable one. What you are saying, in effect, is that we outline a problem but we really do not offer a solution in terms of revenue increases. I think the situation is serious enough that this committee and the Congress should look at every possibility.

The recommendations of the President represent a package which you will undoubtedly consider. We have taken serious objection to only two of them. We have raised questions about three others. We and other witnesses have suggested some other areas that you might look at.

I do not think that it is responsible for business witnesses to say you have to solve the deficit problem, but every time a question is raised about a particular provision, we say thumbs down. I think they all ought to be looked at but they should be looked at on their merits in terms of sound tax policy, in terms of revenue increases, in terms of whether you go for a temporary action and so on.

So I understand your question and I appreciate the thrust of it.

Mr. PICKLE. Well, may I just again—oh, I am on Mr. Gibbons' time. I will wait, Mr. Chairman. [Laughter.]

Chairman ROSTENKOWSKI. Mr. O'Brien, we are talking about a deficit in the neighborhood of $150 to $160 billion. The President has made some proposals. One of them, of course, is the corporate minimum tax, to which all of you object. You do business in this country. We furnish the dollars to support the armed services. The armed services protect U.S. businesses abroad with the tax dollars of U.S. taxpayers. The President is a very patriotic individual. He has made a suggestion regarding a corporate minimum tax. However, the business community objects to it.

Shouldn't we expect the business community—corporate America—to make a minimum contribution for the privilege of doing business in this country, for the protection that our armed services render to you both here and abroad?

Mr. O'BRIEN. I certainly would agree with the general principle, Mr. Chairman, but I would suggest that there is already a contribution being made to the extent that substantial income taxes are already being paid.

Chairman ROSTENKOWSKI. Are you suggesting that the business community should not pay any taxes?

Mr. O'BRIEN. No; I did not say the corporate community should not pay anything, but I am saying there is already evidence that taxes are being paid.

Chairman ROSTENKOWSKI. If we were going to try to reduce the deficit to under $100 billion, we would actually have to eliminate some of the entitlement programs or at least cut them back. Are you suggesting, then, that we cut the COLA in social security because there are big dollars there. Is that one of the areas where we have to make some cuts?

Where can I get a consensus from the business community with respect to tax increases or entitlement cuts that can get this deficit under $100 billion? Every time we suggest a particular area or the President suggests a particular area, as Mr. Stewart pointed out, everybody says that is my sacred bull, do not gore it.

So where do we go? We are running for reelection and that is a very important ingredient to members that sit on this side of the table. What do you suggest?

Mr. O'BRIEN. Well, I am certainly not suggesting that the defense budget should be inviolate. I certainly believe that in any organization, Government included, when you are talking about revenues and expenses of this magnitude it is inconceivable to me that you cannot find savings in many areas.

Chairman ROSTENKOWSKI. Last year, we did quite a job of cutting programs to the point where the constituency out there is almost in revolt. I do not know where we go, if we are sincere about trying to lower the deficit. That is evidently the signal for which all of you are waiting so that the investment that was predicted actually takes place.

Mr. O'BRIEN. I am simply saying that I am convinced the deficit can be reduced. I am saying that some of the defense expenditures can be reexamined and that can reduce some of the deficits. I also think some of the entitlement programs should be reexamined, and I am convinced that there are areas where something can be done.

I also feel that the deficits are particularly——

Chairman ROSTENKOWSKI. Mr. O'Brien, we have the privilege of saying that we also think there are some areas in the entitlement programs that ought to be cut. We have to be a little more specific about what we are going to do. There is a reaction in the country when we become very specific. There is a reaction between the four of you with respect to some of the proposals that the President has suggested.

Mr. Conable will inquire.

Mr. CONABLE. Mr. Chairman, it is easy to get into a dialectic impasse here. I understand what you gentlemen are saying. You are saying that we are extremists and we have to do something. You wish also to express your opinion about taxes and how they affect you. I appreciate your coming in and giving us your testimony.

You understand that we have to ultimately make decisions. There is nothing, just because a proposal has been made, that means it has a strong presumption in its favor. It means somebody thought it was a better idea than something else. The whole purpose of these hearings is not to bludgeon you into saying "Yes, whatever you want," but just to get your opinion. I appreciate your coming in and giving us your opinion.

Let me say, Mr. Baldwin, we are very proud of the Rochester Tax Council and are grateful for you appearing in a special way and giving us your evidence.

Mr. Stewart, I wanted to talk to you about the completed contract method because you moved rather quickly on that. You have been before the committee many times and we respect your judgment here. Would you delineate with a little more particularity the philosophical objections to that?

As I understand it, it is something like the problem of the estimate on corporate taxes. You do not know if you are going to have a profit or not until you get down the way toward a completed contract, and that becomes a cash management initiative to a certain extent if you assume a certain degree of profit. And as I understand it, to what extent expenses are current and what expenses are terminal is also subject to definition and creates serious problems.

Another objection, I understand, is that since the completed contract method is used rather heavily in defense procurement, the result can be just simply a transfer of an additional tax cost to the Pentagon and ultimately no net saving to the Government at all; in others words, we will collect more in taxes, but those taxes will be in some way passed along as costs to the ultimate procurer, the Government in this case.

Now, are there other things that ought to be said about this proposal, or are those the major objections?

Mr. STEWART. I think those are the main objections, with perhaps one addition, namely, that there may be some technical modifications in the regulations with respect to the question of taking period costs before the matching at the end of the completed contract, with respect to separability where more than one contract might conceivably be involved, and certain other technical problems might be addressed.

The Treasury really is coming forward with a proposal that scuttles the completed contract method and offers a complex alterna-

tive which is so complex and so unsatisfactory that no one could possibly live with it, the so-called progress payment method.

So I think you have put your finger on the essence of the problem. This is a method that has been in effect now, I believe, from all the way back to 1918. I suspect that the reason that the Treasury Department asked you to repeal it statutorily is because they are queasy about trying to repeal it through regulatory action.

Mr. CONABLE. Thank you very much.

That is all, Mr. Chairman.

Mr. GIBBONS [presiding]. Mr. Pickle.

Mr. PICKLE. I have enjoyed the colloquy with you, gentlemen.

I think I will ask Mr. Brophy one additional question. You said we needed to do something about entitlements. I would agree. I think we are never going to get control of the Federal Government until we get better control of the entitlement programs. I think that probably would go across the board, even including social security, but that is going to be an extremely difficult area to invade because we have the President, we have the Speaker, both saying cut everything but that.

And as we consider it, can we also include that in some manner? It puts a lot of us to task because these are the very lowest of our wage earners, in many cases, and we are hurting the poorest in this land. Now, if the Budget Committee or this Congress were to get into some changes in the entitlement programs for social security, how would you feel about also saying to the social security recipients that the Government, if we cut back on entitlements, also must stand ready to help you and the solvency of some of the trust funds such as the retirement funds?

In other words, would you be willing for the Government to assure the social program that the U.S. Government could help from general revenues or from the medicare fund to beef up the retirement fund? We are going to be faced with that question within the next year. The question is, Where are we going to get the money?

So as you consider cutting entitlements in that area, would you also give good faith and credit to the Federal Government to help assure the solvency of the retirement system in this critical time or at some critical moment?

Mr. BROPHY. It is a very complex subject, as you know so very well, Congressman Pickle. There is a bipartisan commission that has been appointed to study the matter at this moment. I would think that at this particular point in time the segments of entitlements that this committee and the Congress should address is the indexing aspect of it.

I think if you can address that now, you can have a major impact on the budget deficit over future years. I think the whole idea of the future viability of the system is one that should await the outcome of this commission's study.

Mr. PICKLE. That may well be the course we will take, but that report will not be made until November, in all likelihood, so it would have no effect except a year from now.

Mr. BROPHY. I understand that and I understand that this being the year that it is, that is probably politically the best that one can expect.

Mr. PICKLE. I thank you, sir.

Mr. STEWART. May I offer a point? There are a number of ways in which you could take some temporary action, one in particular, in that you could freeze further indexation for what we consider to be an emergency procedure and then await the recommendations of the Commission. I am concerned about the old saw that if you want to bury a problem or lose an idea, give it to a committee. I am afraid you are going to have to face up to the same problems, except probably in a nonelection year after the Commission report, that you have now.

Mention was made of the old theory that it is not thee, it is not me, it is the man behind the tree. I think what we all recognize is that the big money that is not being touched now, that you have not already addressed in connection with reductions in expenditures, is in entitlements and in defense. That is where the big dollars are. I think they have to be addressed.

I think also, if I may just conclude, that if in your wisdom you feel that you have to open up the 1981 act, then you have to open it up. That is how serious I view the situation.

Mr. PICKLE. Well, perhaps we could consider a cut in the entitlement for social security for this year and for the next and then look at the long-range what do we do. That is a possibility, is it not? You are nodding your head that you judiciously affirm my observation. That is fine. Somebody should point out to you that I do not think that I would want to try to put a collar on a bobcat once, and get it all cut to pieces, and come back 2 years later and put another collar on him. I do not think Congress is going to want to tackle that wildcat more than just once.

Mr. GIBBONS. Mr. Rangel.

Mr. RANGEL. Mr. Stewart, some of us believe that there is a large amount of money out there in that 1983 tax package which have nothing to do with defense and entitlements. I do not know why it always shocks me that the business community welcomes the opportunity to cut programs that are out there to service the oldest of Americans and the poorest of Americans, and yet when you come anywhere near making any kind of sacrifice and you would have us believe that we just can touch the tax package of 1983.

I suspect all of you would support some type of system where we would just remove the corporate tax altogether and you just send in what you think is fair and equitable to the Government, because certainly you did not have this tax package 2 years ago.

It was not something that you expected, it has not put America back to work, it has not restored confidence in the system, and yet you do not want anything to interfere with a system that year after year, decade after decade, you find that the corporate part of the tax system, they are carrying less and less of the tax burden, and more and more we find it being shifted to the individual taxpayer.

Mr. Brophy, you pointed out you got less under this than the last one, but the corporate structure pays less in the overall percentage of taxes than the individual taxpayer. You start looking and see what the majority of Americans got out of this tax package, and I certainly would like to see a list of entitlements that the corporate officers enjoy.

I really would like to have an analysis of the incomes of the entitlements, the fringe benefits of entitlements, the loopholes of entitlements, the deductions of entitlements, and I am willing to put Members of Congress right in the same pot and ask whether or not you think some of these percs and entitlements should be reduced.

True, it would not produce the income that we could get if we just hit the millions of poor and old Americans, but it might allow you a little sensitivity instead of just coming down and saying we have to look at the entitlements. You have to look at it. We have to vote to restrain the growth of entitlements.

You say we have to look at domestic spending. Well, you look at it, but we have to make the cuts for people who do not have the luxury to be able to come down here and testify. I just wish that if you would take a look and see what this Congress has given you, that you just would not look at the entitlement programs and the programs that service people and say that no one can touch the income tax benefits that you and your corporations have received.

It is just not fair to say that we all have to make sacrifices when there is just not one thread of testimony that indicates that the business sector is willing to make any sacrifices at all.

If I missed it in any of your testimony, you can point out to me where you are willing to carry any of the burdens of the crunch that we find ourselves in.

Mr. BROPHY. I would like to respond if I may, Congressman Rangel. First of all, I think you will find that if you looked at corporate profitability over the last two decades, you would see a substantial decline in profitability, a substantial increase in corporate debt, a substantial decrease in corporate liquidity, a substantial weakening of our whole corporate system.

The jobs in the United States are provided by business. If we reach the point where the only place you can go to get a job is with the Government, we are indeed going to be in deep trouble.

Mr. RANGEL. No one is supporting that theory.

Mr. BROPHY. I know you are not, but this does mean we have to have a healthy business environment. The changes in the tax law last year were to encourage savings and investment and to improve our competitiveness in the worldwide economy.

Mr. RANGEL. It has not brought about savings, it has not brought about investment, and it has not improved the job market for those people who you are asking to cut their entitlements.

Mr. BROPHY. I think, as so many things, we have a system that was developed over a long period of years and we could not expect an immediate response. It will take time. Many of our investment decisions are planned over a period of 3 to 5 years. I think an opportunity does exist and I think that all of us in the business community are supportive of the concept of protecting the poor, weak, and aged and those that cannot help themselves.

Mr. RANGEL. No one testified to that. Every time somebody talks about taking a look at defense spending, the great profile in courage is different this year than last year in that we can now look at defense as though this is just one change in the whole——

Mr. BROPHY. That was not my testimony, Mr. Congressman. I said we had to look at defense. If we look at the entitlement programs, only 17 percent of that entitlement program is a needs test

type program. There are lots of them, including wealthy people who are getting paid——

Mr. RANGEL. Well, Mr. Stewart shook his head when somebody asked about COLA's with social security. Would you suggest that we means' test social security?

Mr. BROPHY. No, I am not suggesting that. I suggest that part of the work of this commission needs to be a reexamination of the Social Security Commission because I do not think it can continue to survive under the present ground rules.

Mr. RANGEL. How, Mr. Brophy, could we reexamine the tax package of 1983 to see whether or not we were right or whether we were wrong. Just because it is beneficial to business people does not mean we are right. You say giving more time, right?

Mr. BROPHY. Obviously you are free to reexamine any tax package any time, but I think you are not going to have a settled business environment if you change the rules under which business has to operate every 6 or 9 months.

Mr. RANGEL. Well, business will not have a good environment if the majority of the American people believe that they have been treated unfairly based on a class system and based upon a government that provides precedential and preferential treatment to the wealthier part of the society and to the corporate structure.

If you do not believe that this is not a growing tendency throughout the country, then I suggest that you contact the staff of this committee that has been around the country, and you will find that more and more people believe that the whole tax package was geared toward the haves and that the whole social service package is now being geared to cut back for the have nots. It is unhealthy for them, and in my opinion it is just as unhealthy for business.

Mr. BROPHY. Congressman, I looked at some figures recently to see what had happened over the last 40 years to the budget. I went back to 1940 so I would not be taking a war year. If I recall—and these figures will not be penny accurate—in 1940 the Federal Government spent about $74 per individual in the United States. In 1980, that figure had gone up to $2,700. Whether a lot of people had improved substantially in reference to the amount of money spent I would really have to doubt.

I do not think that the general attitude of the people in the United States today is we can spend ourselves out of these problems. Therefore, we have to look at the spending side of our economy if we are going to get our deficts under control.

I think all the gentleman here has said is nothing is sacrosanct; everything should be looked at.

Mr. RANGEL. I am not arguing with you. I am saying we can suspend some of the tax cut, too, you know, in an effort to balance the budget. It could be a package of raising revenues and cutting back spending, but all of your testimony just dealt with spending.

Mr. BROPHY. I do not think that is accurate, sir. My full testimony has been submitted, and it covers both sides.

Mr. STEWART. Mr. Congressman, I would like to read three sentences from our statement which is really in conflict with the characterization you made of business testimony, at least as far as we are concerned.

We said that a whole range of alternatives should be examined. In addition, we specifically said that a significant number of Members of Congress have suggested that certain provisions of the Economic Recovery Tax Act of 1981, referring to your 1983 package, particularly, should be reexamined. If that were to take place, we would certainly urge that any reductions in benefits be even-handed as between corporations and individuals.

This prompts us to observe more generally our feeling that if a significant reduction in the deficit beyond the spending cuts achievable is to take place, it will be necessary to put together a program which will impact a range of interests throughout the economy. That is an attempt to say that nobody should be sacred.

Mr. RANGEL. Thank you for the clarification, Mr. Stewart.

Mr. GIBBONS. Mr. Vander Jagt.

Mr. VANDER JAGT. Thank you, Mr. Chairman.

I would like to welcome the members of the panel here this morning and thank you for your contribution. There seems to be unanimity on the panel that we are in serious trouble in terms of our deficit. There seems to be unanimity that we should cut spending to reduce that deficit. And then, Mr. Brophy, you pointed out specifically, that after we do all of the above and still have too big a deficit, then we ought to look at raising taxes. But you suggested that we look at raising taxes, if necessary, by deferring or stretching out the third year of the individual tax cuts.

Now, business in 1981 and 1982 got two-thirds of all the tax relief. If we have to raise taxes, do you not think it would be fairer to take a look at raising taxes on businesses as well as on individuals instead of putting all the burden on the backs of individuals?

Mr. BROPHY. Sir, if I could make one correction. First of all, I said if there had to be tax revenue raised that it should come in consumption taxes.

Mr. VANDER JAGT. Which falls primarily on the individual.

Mr. BROPHY. All taxes end up falling on the individual, and obviously——

Mr. VANDER JAGT. But consumption taxes are clearly more direct than any other.

Mr. BROPHY. Sir, consumption taxes will affect individual industries whose products are subject to the consumption tax. In looking at excise taxes I realized that one that is being considered is one on the telephone industry, which is an industry in which my company is involved, and I have not objected to that.

I have said, The Business Roundtable has said that as a last resort and only as a last resort that we should not eliminate the third year part of the individual tax cut but should be willing to consider a stretchout.

Mr. VANDER JAGT. Yes. If we reach that position where we are at a last resort, then you turn to the individual for the additional revenue, but not to business. My question is, Since business received $2 out of $3 of the tax relief in the package in 1981 and 1982——

Mr. BROPHY. Sir, that is not so. We received roughly 20 percent of the tax relief in ERTA.

Mr. VANDER JAGT. In 1982. But in 1981 you received roughly 98 percent. So you put the 2 years together, and business got $2 out of every $3 of tax relief.

If we are talking about last resort and dire circumstances, would it not be fair then to suggest that maybe business, along with the individual, ought to share part of the sacrifice?

Mr. BROPHY. I think business is prepared to bear its fair share. I think we believe that the minimum tax proposal is ill-designed to spread that burden equally over industry.

Mr. VANDER JAGT. You have brought up the minimum tax proposal, and many of you have made a good case against the minimum tax as it has been proposed. I think most of you, if not all of you, pointed to the good effects of the safe harbor leasing; but I think some of you pointed out that there may be abuses; so that although the concept should be retained, we ought to perhaps take steps to correct some of the more flagrant abuses.

Would not that same reasoning apply? Would any of you maintain that it is seemly for any corporation to make huge net profits and pay no tax?

Mr. BROPHY. I think all of us would agree that corporations that have true economic income should pay taxes on that income.

Mr. VANDER JAGT. My question is, Since there are such deficiencies in the proposed minimum tax, and we agree that it is not seemly for corporations who make huge profits to pay no tax, then what would you recommend?

Mr. BROPHY. I think the basic problem that the minimum tax was designed to address originally, but really did not address, was the problem of the perceived abuses in safe harbor leasing. In my testimony I said that modifications would be desirable to address that problem.

Mr. VANDER JAGT. Long before safe harbor leasing we would have, every year, corporations showing profits, but with taxes which were negligible.

Mr. BROPHY. I believe that is also a problem in the insurance industry; that the insurance industry has recognized needs to be addressed.

Mr. VANDER JAGT. Since we have agreed that that certainly is not good cosmetically, what would you propose to address that situation, any of you?

Mr. BROPHY. I think you should look at each of the specific problem areas and address those individually, amending or revising the existing tax laws where they are required rather than taking a shotgun approach where they will possibly injure the innocent bystanders.

Mr. VANDER JAGT. Thank you. I yield back, Mr. Chairman.

Mr. GIBBONS. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

I would assume that you would all concur, or no one on the panel would disagree, that eliminating or reducing our deficit should be a cornerstone to improved economy. Can we all pass on that?

[The panel members nod in the affirmative.]

Mr. STARK. If that is the case, we look at wider deficits than projected by anybody's projections, whether it is the administration or the CBO or whoever, we are looking at widening deficits for a long time. For a long time we have been looking at constant deficits. We

have never closed the budget gap. Now we are looking at one that suddenly widens.

Given that, do you really feel that it is essential to the economy that we have the increase in the ACRS that is scheduled to come on stream in 1985 and 1986, which are tremendous revenue losers? In other words, we are scheduled to go in 1985 to 175 percent and in 1986 to 200 percent. Is there any reason we could not forego that as a way to get the deficits under control?

Mr. Brophy.

Mr. BROPHY. Congressman, I think there has been a general agreement on both sides of the aisle in Congress, for quite a long period of time, that capital recovery in the United States had fallen well behind that of our foreign competitors. We face a particularly difficult time where some of our major infrastructure industries are trying to reinvest and modernize to catch up with what their foreign competition has already done.

I cannot imagine anything that would perhaps be more destructive to that effort than to take away from them today the capital recovery provisions that were provided by Congress last year and really were a broad, bipartisan effort for an outcome of 10-5-3 that had such tremendous support.

Mr. STARK. How would you go about that?

Mr. BALDWIN. I suppose as a last resort we could support pushing them out. Possibly another idea would be a temporary surcharge of some sort.

Mr. STARK. Mr. Brophy, you are already scheduled to pick up almost $2½ billion of other taxpayers' money in GTE's own revenue lost because of ACRS. I can understand your willingness not to have that increased, because you are only getting $2.3 billion now. I can understand that your interest is rather parochial, and it might exceed your interest in the economy in general. But I just wonder what I say to people in the service industry who may not be treated so munificently as some of the capital intensive industries.

Another thing is——

Mr. BROPHY. Congressman, if I may respond to that, I do not want to just sit silent. The capital that is retrieved is capital that is earned through investment. The only way that capital is derived by a company is by making very substantial investments. Those very substantial investments are the very essence of job creation in this country.

Mr. STARK. I have no trouble with using capital. I just have trouble with using taxpayers' money.

Mr. BROPHY. The capital has to be recovered over the life of the property. We have been faced with a situation where we were not able to recover our capital on anywhere near the terms that were competitive with either the other industries in the United States or those abroad.

Mr. STARK. As far as dealing with the interests abroad, it is very interesting. You know, Japanese executive compensation, even if you count fringe benefits, appears to be far lower than our executive compensation in the U.S. industries.

Maybe it is not just that labor and government need to cut back their expenditures, but maybe if at the corporate level we did some

belt-tightening, if a better management team might help our competitive advantage with some of these companies overseas.

Mr. BROPHY. I do not believe you will find that executive compensation at any level has been something that has had any impact on either goods or services.

Mr. STARK. But it is certainly more costly than the Japanese industries.

Mr. BROPHY. That gets back to the issue we were talking about earlier.

Mr. STARK. Somebody just said to me do not blame me, do not blame thee, blame the fellow behind the tree. I am beginning to wonder if in the failure of our industry, we might begin to look at its management rather than its tax structure. Perhaps we should begin to look in-house in this country to see if we had a little smarter, harder working executives running our major industries we might not be more profitable.

Mr. BROPHY. Congressman, I am not here to defend the brainpower of American industry, but I would be happy to discuss with you at some time the Japanese problem. Obviously they do not support the defense establishment that we support. They have many advantages from that point. They have a closed border to foreign imports. There are many other aspects of it that have to be examined, and I would be very happy to visit with you on those.

Mr. STARK. Thank you, Mr. Chairman.

Mr. RANGEL [presiding]. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Gentlemen, some of you touched on this in your written testimony—and nobody has discussed it orally yet, I do not believe—about the administration's proposals to limit the use of industrial revenue bonds, something that interested myself and the acting chairman, the gentleman from New York. What comments do you have on these proposals by the administration?

Mr. STEWART. Our testimony does cover that, and I did refer to it orally. We feel that the type of cutback that is proposed is counterproductive in terms of other goals we have in this country. The procedural changes for the most part we do not quarrel with. That is our position.

Mr. MOORE. Does anybody else have a comment?

Mr. O'BRIEN. We did not testify on that subject in our oral or written statements, so we really have not taken any position with respect to that. The testimony earlier this morning, which was given by Governor Carey, I think, referred to testimony from the Public Securities Association which has taken a position on that subject.

Mr. MOORE. Anybody else?

Mr. BROPHY. The roundtable has not taken a position on that either, Congressman Moore.

Mr. BALDWIN. The position of the Rochester Tax Council is that if it was deemed that this was to be in the better interest to do away with it, we could live with it.

Mr. MOORE. Let me ask those of you who do have an interest in the retention of the existing law, is not the net result of the industrial revenue bonds to simply allow a businessman to obtain lower

interest rates than he would normally pay for his capital to build a certain business or structure or whatever?

Mr. O'BRIEN. Yes, that is part of the dimensions of the situation. There is usually a rationale for it because it enables him to establish a situation in a locality, a plant, whatever it happens to be, which in turn advantages many people: jobs, stockholders, everybody else.

Mr. MOORE. I did not hear you.

Is there any information to indicate whether the establishment of that particular locality you were just referring to would have taken place or would not have taken place were it not for this industrial revenue bond?

Mr. O'BRIEN. I have no scientific information, but having been in one way or another involved with the activity from time to time over the years, I believe there are instances which if that opportunity did not exist the situation would not have come to pass, the plant would not have been established there.

I cannot tell you scientifically any more than that.

Mr. MOORE. Does anybody have any studies on that?

Mr. STEWART. We do not have any studies, but I think this particular subject has been examined by tax writing committees on both sides of Congress many times before, and the prevailing sentiment that has persuaded the Congress has almost always come from local and State, county, and so forth government representatives, even though there is a private interest involved also.

I think you will find that there is a record demonstrating the view of the local authorities that they need this technique in order to achieve certain local capital formation purposes, etc. I am sure you will find that spread on the record.

Mr. MOORE. Well, I have, and I have found it spread now with great disagreement. The fact that they are not now able to sell bond issues to build schools and bridges and whatever, results from the flooding of the market of tax-exempt IDB's.

What I am really trying to get at is: Is this really a necessary item for business? If it is not, is not it something we could eliminate from the tax code and save some money? Are you not really after the lowering of interest rates, and this is just a gimmick that some people can use to get lower interest rates at a time when they are high?

That is what I am trying to get at. I am trying to give you gentlemen an opportunity to educate the members of the committee who are here, and who are looking at this critically, I might add.

Mr. O'BRIEN. Well, with absolutely no basis for making a comment on a scientific level, I think it is probably mixed. In certain instances there are some very real reasons why they should be established based on the desire of local interests as well as the interests of a particular company. It may be that in certain other instances it is less persuasive, the argument, but overall I think there are some very good reasons why from a local as well as a business interest they would be established there.

The other dimensions of that, of course, are what is the ultimate beneficiary.

Mr. MOORE. Would it not always be in the interest of the business entity to obtain the lowest interest rate possible? If you could

get a two-or three-point break with the revenue bonds, you could go either way no matter what the climate is in our economy? Would not it always be in your interest to have that kind of an interest rate?

Mr. STEWART. These investment decisions by companies are situs decisions. They are not made solely on a two-point or three-point increase in interest rates.

Mr. MOORE. Does this enter into it at all?

Mr. STEWART. Sure it enters into it, but as one factor.

Mr. MOORE. Can you prove that? Can you give me some examples of locations that you made that you would not have made because of the existence of an industrial revenue bond? That is what you tell the local mayors and city councils and that is why they pass these things. We are simply asking do you have economic data to back that up.

Mr. STEWART. I cannot offer you a data base for it.

Mr. MOORE. When you are building an extra McDonald hamburger stand, you use a revenue bond to do it. It is hard to convince me that it would not have been built were it not for that industrial revenue bond.

I thank you gentlemen. My time is expired.

Thank you.

Chairman ROSTENKOWSKI. Does anyone else care to inquire?

Mr. Bailey will inquire.

Mr. BAILEY. I am going to be very brief, Mr. Chairman. I do not really have a question, just a brief comment. I agree very strongly with you on the attitude you have toward the alternative corporate minimum tax.

Mr. Brophy, I am going to particularly address this to you. I hope the Business Roundtable will not be as politicized—I say this to you honestly and this is a personal opinion—as, in my opinion, you were during the last tax package.

I also would hope that all of you could develop a different semantic approach. One of the difficulties with the minimum corporate tax is that it is an absolute misnomer. I think we all know that. It is much better described as a penalty tax.

I think we also know it does discourage investment. It is extremely inequitable. It is a tax on capital. It specifically provides a great deal of pressure in the capital-intensive sector of the economy and it is something that probably does not have an equal anywhere in the world.

I would hope we could combine to get it changed. We desperately need the investment. In fact, probably as far as the last tax bill was concerned, I hope we can dispel those improper connections that are made in the public mind between minimum corporate tax and the issue of profits, and the relationship between the incidence of that tax and profits, which is absolutely none. Rather, we should establish a relationship between its pressure on capital investment and discouraging capital investment and the importance of capital flow to particular companies and industries as the only means to finance basic capital investment.

I also would like to say that I think there are some glaring inconsistencies, Mr. O'Brien and Mr. Brophy, with all due respect, in some of the views about the economic solutions and ways we can

resolve some of these problems. I think the chairman was on target particularly to Mr. O'Brien when he raised the question about a specific solution to this deficit problem and your confidence dichotomy. You have two confidence problems.

We have a deficit we have to finance and not a reasonable solution on how to finance that deficit. We do not finance the deficit. We have a confidence problem on interest rates and investment. Yet if we do not do something with the personal income tax revenue problem, you do the arithmetic, you do not have sufficient revenues outside of at least looking at that area to do something about the interest confidence problem.

But you say that creates a demand problem, and I think you are placing yourself between a rock and a hard place, with all due respect. Those are my views.

Mr. O'BRIEN. Fine.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman.

The people I have talked to have pretty much conceded that in fiscal year 1983 the budgetdeficit will be substantial. Their main concern is that in the out years, 1984–85 and beyond, that we show a reduction or at least some real progress. Second, they say that we have to show a credible deficit figure and not one that is subject to a lot of holes in it.

Could you gentlemen give me your idea of what a credible deficit figure will be for the fiscal year 1983, assuming we can put a budget package together? Perhaps Mr. Stewart?

Mr. STEWART. What would be credible to the financial interests in the economy and so on?

Mr. MATSUI. Yes.

Mr. STEWART. Get it down below the $100 billion, and if possible, as far down as you could get it.

Mr. MATSUI. Mr. Brophy.

Mr. BROPHY. I would think it would be for 1983 desirable to bring it down to two digits, and beyond that I think you would like to see a substantial downward trend.

Mr. MATSUI. Would you say in the two digits? Mr. Stewart says below $100 billion, or are you talking about $75 billion or $80 billion?

Mr. STEWART. No, I do not think that it is realistic to believe that for 1983 you are going to do much better than in the $90 billions.

Mr. MATSUI. Thank you.

Mr. O'BRIEN. I think it should be under $100 billion, but I could not possibly tell you where it should be or whether it should be $75 billion.

Mr. BALDWIN. I would concur.

Mr. STEWART. I guess we all feel that the direction is most important.

Mr. MATSUI. I think that is what seems to be the financial institutions' main concern, that we show a proper direction. Thank you very much.

I yield back.

Chairman ROSTENKOWSKI. Thank you.

Gentlemen, whose numbers are you using with respect to what the deficit is presently estimated to be. Would you be kind enough

to give me an idea what you think it is, because it has been escalating. If it is $114 or $125 or $150 billion, that means we will either have to raise revenues or cut entitlement programs further. That is going to be more and more difficult.

As estimated by CBO, the deficit figures are at $170 billion. You can see the difficulty of our task here. We all would like it to be under $100 billion. I think that is a target that we will try to achieve. But it is not going to be easy.

Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

I want to go through some of your testimony, Mr. Brophy, and see if I really comprehend what you have said in your written statement and then also in answer to questions.

On the broad scope, do I take it correctly that you are saying that the Congress should cut defense spending below the fiscal year 1983 request?

Mr. BROPHY. I think we believe that that should be examined, and in the out year also.

Mr. ANTHONY. We are going to examine it. I will rephrase my question.

Mr. BROPHY. I think there is an opportunity there for reduced Federal spending, yes.

Mr. ANTHONY. So your answer is you think that Congress, in examining it, should or should not cut spending below the President's 1983 budget request?

Mr. BROPHY. When you say the Congress, I think it has to be a bipartisan effort with the President.

Mr. ANTHONY. Let me back up because the President so far has shown no give on defense. I am just talking about the Congress, I am just talking about the House of Representatives.

From reading your testimony, you say that no part of the budget should escape close scrutiny. Can I deduct from that testimony, then, that I would be safe to go back home and tell my business people that you have testified before the Ways and Means Committee that you recommend a close examination of the defense budget and that you are supporting a reduction below what the President has requested in fiscal year 1983?

Mr. BROPHY. We believe that you will find after that examination that that is possible. Obviously you have access to more information than we do, but we believe that is possible, yes.

Mr. ANTHONY. So what I am going to be able to do on my Easter recess is to say the Business Roundtable has said it is possible to cut defense spending below his request?

Mr. BROPHY. We believe that your examination will show that, but you will be the one that makes that examination, yes. [Laughter.]

Mr. ANTHONY. Mr. Chairman, it reminds me of a slippery defense witness I had once in a criminal trial—I am not implying any criminality here. [Laughter.]

But it reminds me of a very slippery witness I had once in a touchy criminal case back home when I was a prosecuting attorney. In those days I had all day long to pursue my line of questioning, I was not limited to 5 minutes. I could have a lot of fun with this if I was back in the courtroom. [Laughter.]

My next question goes to entitlements, the same line of questioning. Can I go back and tell my business community that you have now testified before the Ways and Means Committee that you are recommending that entitlement spending be cut below the President's fiscal year 1983 request?

Mr. BROPHY. I think, sir, that you do not characterize me as slippery on both questions. On the prior question and the current one, I would answer yes.

Mr. ANTHONY. OK. Now, then, in including entitlement spending, you are also including social security in that?

Mr. BROPHY. We are talking about indexing on social security. We are not talking about a cut in social security payments. I want to be absolutely clear on that one.

Mr. ANTHONY. I am clear on that and I agree with you, but I want to go now to page 8 of your statement. Since we are talking about social security but only the COLA part of it, you make a comment that a freeze or delaying of the indexing provisions would not have an adverse effect on needs or means-tested program. Social security is not a means-tested program.

Mr. BROPHY. That is correct.

Mr. ANTHONY. However, I have many people in my district who, right or wrong, have found themselves in such economic circumstances that they have to depend upon the social security payments each month to live on. They now only live on those social security benefits. If we froze them for someone receiving, say, only $250 a month, would that not have an adverse effect on that person versus, say, my father-in-law, for instance, who is in a substantially higher income category yet is eligible for social security?

Mr. BROPHY. Obviously, Congressman, anything that reduces what people anticipate getting has an adverse effect on them from their point of view. There is no escaping that. Clearly this is something that cannot be done in an election year unless it is done with strong bipartisan support. We recognize that, but we have a program that has been growing substantially faster than real inflation rates, in excess of 15 percent a year, I believe, on average.

It does appear that realistically this is something that has to be addressed if we are going to get at the deficits because so much of our Federal spending is tied up in the two programs, entitlements and defense. We do not have a big enough pot to look at them unless we address them.

Mr. ANTHONY. Actually, if we examine entitlements and exclude social security, we will only look at 30 percent of entitlements, because social security takes about 67 percent of the growth of entitlements.

I thank you for your testimony.

Chairman ROSTENKOWSKI. Have you concluded?

Mr. ANTHONY. Yes, sir. I yield back.

Chairman ROSTENKOWSKI. Thank you very much, gentlemen.

The Chair will exercise the privilege of the Chair to select Mr. Malott to testify by himself before the next panel is called. Mr. Malott is here at my request. Please take the witness stand.

Immediately after Mr. Malott's testimony, we will call the next panel.

Bob, welcome to the committee. I am sorry I will not be able to stay here for your opening statement. I must go to the floor and vote, but I will return as soon as possible. Mr. Russo will receive your testimony.

STATEMENT OF ROBERT H. MALOTT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FMC CORP., ON BEHALF OF THE MINIMUM TAX COALITION

Mr. MALOTT. Mr. Chairman and members of the committee, I am Robert Malott, chairman and chief executive officer of the FMC Corp. I represent the Minimum Tax Coalition, a group formed 2 years ago to work for the repeal of the existing minimum corporate income tax.

We believe that this tax is a serious disincentive to the accomplishment of nationally desired objectives established in previous tax codes. I might point out that two members of this committee, Representatives Conable and Bailey, have already introduced H.R. 5206, a bill designed to repeal the existing corporate minimum tax.

For many of the same reasons that we oppose the existing add-on minimum tax, we also oppose the administration's proposal for an alternative minimum tax. This proposal is being presented as a mechanism for closing so-called loopholes in the tax laws.

Let us recognize, however, that today's loopholes were yesterday's incentives, incentives created by this committee and enacted by the Congress for a variety of purposes. Among those purposes were to increase investment in plant and equipment, particularly in mining and other capital-intensive industries, to increase export sales, and finally, to encourage investment in such socially desired purposes as low-income housing.

By creating a larger and more onerous minimum tax, this committee would now be telling those companies that invested just as this committee encouraged them to do, and as a result lowered their tax bills, that you were not really serious about the incentives that you have created.

The coalition I represent strongly opposes this effort to convert investment incentives of previous tax bills into this year's tax preference items for three reasons:

First, this new tax would reverse investment incentives in last year's Tax Act. As all of us are painfully aware, capital spending for new plant and equipment requires long-term planning.

By trying to reverse the tax policies enacted less than 1 year ago for the express purpose of fostering the rebuilding of America's basic industries, the administration is being very shortsighted. This shortsightedness is the most worrisome aspect of the administration's proposal.

The business community's planning and investment strategies are dependent on a consistent tax policy. Last year's tax changes laid the foundation for a major reindustrialization effort, one long overdue, in my judgment. If continued, these changes will be of enormous long-term benefit to industries and the workers they employ.

The administration's minimum tax proposal, if enacted, however, would cripple the economic recovery hopes of many capital-inten-

sive industries by undermining their present plans to modernize through investment. Now is not the time to reverse our vital efforts to retool America's basic industries, actions that are necessary if American companies are to compete effectively with our counterparts in industrialized nations around the world.

Second, the administration's proposal would undermine established capital formation objectives. The proposed minimum tax is, more than anything else, a tax on the investment tax credit. It would blunt the benefits of this incentive enacted to encourage investment in plant and equipment by not allowing a company to use the credit to reduce its minimum tax liability.

Recognize the fact that the impact of the proposed minimum tax would fall unevenly on corporations. Those that have invested heavily in response to the incentives established by this committee and Congress would end up paying the minimum tax. Those corporations that did not invest, that is, those that have not responded to the incentives that have been established, would not have their taxes changed.

Thus, the revenue enhancement proposal, as the administration likes to call it, is falling most heavily on those corporations who have invested for he future. This is absurd if one stops to think that many of these corporations undertook these investments in the first place largely because they could finance them out of lower tax benefits.

Third, depressed industries which can least afford it would be the hardest hit by this proposal. Companies that are just breaking even or generating only small profits must use most of the cash flow they generate internally to keep their existing facilities operating.

The investment incentives provided by last year's Economic Recovery Tax Act, however, are allowing companies in the mining, railroad, and steel industries, for example, to use a portion of their internal funds to make productivity-increasing investments in plant and equipment. In order to pay for this new, expanded minimum tax, those companies would be forced to divert critical funds away from their capital investment programs.

In many cases companies will actually be worse off than they would have been if the 1981 Tax Act had never been passed in the first place. Moreover, this minimum tax proposal comes at a time when many of these industries are already bearing the brunt of the current recession.

In conclusion, the Minimum Tax Coalition understands the budget pressures that you and members of the committee face this year. However, we believe the incentives in the 1981 act will work if they are given time to work. The long-term benefits of revitalizing U.S. industry and reversing the downward trend of productivity will be new job creation, lower unemployment, faster economic growth and, in the long run, increased Government revenues.

Toward this objective we strongly urge that the committee reject the administration's minimum tax proposal and that the existing addon minimum tax be repealed as well.

Thank you.

[The prepared statement follows:]

STATEMENT OF THE MINIMUM TAX COALITION

SUMMARY

The Minimum Tax Coalition, a group of mining, railroad, shipping, and steel companies, strongly opposes the Administration's minimum tax proposal. If passed, this proposal will cripple the hopes of economic recovery for certain vital segments of American industry, reverse important tax policies established less than one year after they were enacted, and devastate a major effort currently underway to retool America's basic industries to allow them to continue to compete effectively with their counterparts in other industrialized nations. The Coalition also believes that for many of the same reasons enumerated below, the existing add-on minimum tax should be repealed.

This policy reversal upsets many investment incentives in the 1981 tax act.

The effect of the President's minimum tax proposal will be to selectively offset tax incentives to those capital-intensive industries vital to our national security and our industrial base less than one year after those same investment incentives passed Congress. This result will seriously erode business confidence in government and adversely affect strategic planning decisions being made by industry.

This proposal undermines capital formation objectives.

The proposed minimum tax is, more than anything else, a tax on the investment credit. The Administration's proposal blunts the benefits of this tax incentive by not allowing a company to use the investment credit to reduce its minimum tax liability. This significantly hinders the ability of many capital-intensive companies to fully utilize the credit. And this result occurs without even naming the investment credit as an item of preference.

To the extent that the minimum tax does attach to items named as preferences, the selection of many of these special deductions and exclusions is unwise and counterproductive.

Depressed industries will be the hardest hit by this proposal.

The President's minimum tax proposal will have the unfortunate effect of hitting especially hard those industries which can least afford it.

Corporations experiencing low profitability in capital-intensive industries use most of the funds they generate internally to keep their existing facilities in operation. Because of the investment incentives provided for in the Economic Recovery Tax Act of 1981, internal funds in the mining, railroad, shipping, and steel industries are now being freed up to make the necessary investments in plant and equipment to increase productivity. Because of their economic position, these industries will be forced to divert critical funds away from their capital investment programs in order to pay this new, expanded minimum tax. In certain instances, some companies in the Coalition will actually be worse off under the proposed minimum tax than they would be had the 1981 Tax Act never passed Congress.

In addition, this minimum tax proposal comes at a time when these industries are bearing the brunt of the current recession. An increase in taxes at this time will only exacerbate an already difficult situation, further hindering vital reindustrialization efforts.

The minimum tax places domestic industry at a serious competitive disadvantage.

America's basic industries are engaged in an economic war with their foreign competitors. If the United States is to win this battle, there needs to be a massive infusion of new funds into American industry to increase productivity, stimulate the economy, and create jobs. The Economic Recovery Tax Act has for the first time severed those restraints that historically have caused a serious international disadvantage to the U.S. private enterprise system. The Administration's minimum tax proposal would again deprive many capital-intensive industries of this long awaited and crucial equalizing force in exchange for only a minor increase in Treasury revenues.

The minimum tax may cause an overcentralization of industry.

An unintended effect of this tax proposal may be the further centralization of American industry as the minimum tax may encourage the takeover of capital-intensive industries by wealthier corporations. Such tax-induced mergers clearly are not in the national interest, having the dangerous long-term result of overcentralization of major industrial segments of the economy.

CONCLUSION

The Coalition agrees that reducing the federal deficit is vital to the long-term strength and security of the nation. However, we would ask the Committee not to reverse much of last year's legislative accomplishments. We believe the incentives of

the Economic Recovery Tax Act will work, if they are just given a reasonable period of time to work. The long term benefits in jobs, economic growth, and government revenues will emerge, if they are given time to emerge. Faced with immediate short-term budget pressures, we recognize we are asking much of the Congress. But we also firmly believe we are on the threshold of a new era of economic growth and strength for American industry.

STATEMENT

Mr. Chairman, and other distinguished members of the Committee, I am Robert H. Malott, Chairman and Chief Executive Officer of the FMC Corporation. I represent the Minimum Tax Coalition, a group of mining, railroad, shipping, and steel companies vitally concerned and affected by the President's minimum tax proposal.

Let me say at the outset, Mr. Chairman, the companies I represent are most concerned about the potential effect of the Administration's minimum tax proposal on business planning and investment. Capital spending in new plant and equipment requires long-term preparation and planning and I believe the Administration is being short-sighted by trying to so quickly reverse important tax policies established less than one year ago to rebuild America's basic industries. This proposal, if enacted, will cripple the hopes of economic recovery for the mining, railroad, shipping, and steel industries by completely devastating present plans to invest and modernize in new plant and equipment. Last year's efforts to lay the foundation for a major reindustrialization effort were of tremendous benefit to workers, industry, and the future economic health of the nation. Now is not the time to turn back the clock on this effort to retool America's basic industries to allow them to continue to compete effectively with their counterparts in other industrialized nations.

Let me explain further why the Coalition I represent strongly opposes this effort to convert last year's tax incentives into this year's tax preference items.

BACKGROUND

The fundamental objective of the tax incentives provided to business in the Economic Recovery Tax Act of 1981 was to increase employment and economic growth through the reindustrialization of American business. The long-term goal was to ensure that U.S. industry had the incentives to continue to match and surpass its foreign competitors. The Act was aimed at infusing new capital into industries such as mining, railroads, shipping, and steel which have been staggered by heavy tax burdens, compared to that experienced by their competitors overseas.

These industries have responded to the opportunities afforded in the 1981 Act by pumping billions of dollars into new plant and equipment in the past year. The steel industry alone has announced well over $6 billion in capital spending in the last year, more than any other comparable period for this industry since World War II. The mining and railroad industries have also made major commitments to capital investment programs partially in response to the incentives provided in last year's tax bill.

Just as the reindustrialization effort has begun to gather steam, however, the President has offered a minimum tax proposal which would deal a deeply damaging blow to the move to retool American industry. The Minimum Tax Coalition is a group of companies concerned that this proposal will have a particularly serious effect on depressed, capital-intensive industries in their efforts to increase productivity and outperform business in other industrialized nations. The Coalition believes the Administration's alternative minimum tax concept is extremely harmful to certain segments of American industry and should not be enacted for the reasons enumerated below. The Coalition also believes that for many of the same reasons, the existing add-on minimum tax should be repealed.

This policy reversal offsets many investment incentives in the 1981 Tax Act.

Last year's Act offered important incentives for capital spending in new plant and equipment. Capital investment, however, requires consistent government policies, and the long-term success of the reindustrialization of American industry will depend importantly on a sense of continuity and trust between government and business. The effect of the President's minimum tax proposal will be to selectively offset tax incentives to those capital-intensive industries vital to our national security and our industrial base less than one year after those same investment incentives passed Congress. This result will seriously erode business confidence in government and adversely affect strategic planning decisions being made by industry.

This proposal undermines capital formation objectives.

The proposed minimum tax is, more than anything else, a tax on the investment credit. It will also be haphazard in application as it distorts the central concept of tax credits: neutrality.

The investment tax credit was enacted to promote capital spending in plant and equipment by reducing a corporation's income tax by the amount of the credit. Like all credits, the investment tax credit is designed to provide a uniform tax result among corporate taxpayers.

The Administration's proposal blunts the benefits of this tax incentive by not allowing a company to use the investment credit to reduce its minimum tax liability. This significantly hinders the ability of many capital-intensive companies to fully utilize the credit. And this result occurs without even naming the investment credit as an item of preference. Further, corporations with no tax preferences may be subject to minimum tax liability, while others with abundant tax preferences may not.

To the extent the minimum tax does attach to items named as preferences, the selection of many of these special deductions and exclusions is unwise and counterproductive. These so-called preferences were enacted into law to stimulate capital formation and to provide for badly needed investment. The taxpayers who need these incentives most, and who have responded by making the desired investments, are the very ones who will be penalized by this proposed minimum tax.

Depressed industries will be the hardest hit by this proposal.

The President's minimum tax proposal will have the unfortunate effect of hitting especially hard those industries which can least afford it.

Corporations experiencing low profitability in capital-intensive industries use most of the funds they generate internally to keep their existing facilities in operation. Because of the investment incentives provided for by the Economic Recovery Tax Act of 1981, internal funds in the mining, railroad, shipping, and steel industries are now being freed up to make the necessary investments in plant and equipment to increase productivity. However, as a result of the minimum tax proposal, fourteen companies in the mining industry will have to pay some $300–$400 million in additional taxes over the next three years. Six major companies in the domestic iron and steel industry, also undergoing a major reindustrialization effort, will have to pay well over half a billion dollars in additional taxes over the same period. Because of their economic position these industries will be forced to divert critical funds away from their capital investment programs in order to pay this new, expanded minimum tax.

It is important to understand that the investment tax credit, as presently structured, provides a valuable source of investment funds for these capital-intensive industries. The President's minimum tax proposal would, in most cases of capital-intensive companies, substantially defer or cancel about 25 percent of the value of the investment tax credit. In certain instances, some companies in the Coalition will actually be worse off under the proposed minimum tax than they would be had the 1981 Tax Act never passed Congress.

In addition, this minimum tax proposal comes at a time when these industries are bearing the brunt of the current recession. The capital-intensive industries represented by the Coalition are facing depressed demand, declining production, and high rates of unemployment. An increase in taxes at this time will only exacerbate an already difficult economic situation, further hindering vital reindustrialization efforts.

The minimum tax places domestic industry at a serious competitive disadvantage

Foreign government encouragement of productivity and reindustrialization in their own industry has generally placed U.S. business at a serious competitive disadvantage. It is estimated that Japan, for example, spends some 21 percent of its GNP on industrial investment while the United States spends only about 10 percent. To illustrate further, in 1968 Toyota spent some $16,600 per employee on equipment and machinery, while General Motors spent about $11,900. By 1978 Toyota was spending $40,800 per employee. General Motors' ratio remained the same at $11,900.

America's basic industries are engaged in an economic war with their foreign competitors. If the United States is to win this battle, there needs to be a massive infusion of new funds into American industry to increase productivity, stimulate the economy, and create jobs. The Economic Recovery Tax Act has for the first time severed those restraints that historically have caused a serious international disadvantage to the U.S. private enterprise system. The Administration's minimum tax proposal would again deprive many capital-intensive industries of this long awaited and crucial equalizing force in exchange for only a minor increase in Treasury revenues.

If the private enterprise system is to survive and prosper in the face of nationalized and foreign government-supported competition, this country must provide the

industrial segment of its economy with the necessary tools through an economically viable income tax system. The minimum tax only places an artificial restraint on this type of industrial investment and growth.

The minimum tax may cause an overcentralization of industry.

An unintended effect of this tax proposal may be the further centralization of American industry as the minimum tax may encourage the takeover of capital-intensive industries by wealthier corporations. Such tax-induced mergers clearly are not in the national interest, having the dangerous long-term result of overcentralization of major industrial segments of the economy.

CONCLUSION

Mr. Chairman, the Coalition I represent understands something of the budget pressures you and Members of the Committee face this year. We face similar pressures in our businesses every day. We agree that reducing the federal deficit is vital to the long-term strength and security of the nation.

However, the Coalition would ask the Committee not to reverse much of last year's legislative accomplishments. We believe the incentives in the Economic Recovery Tax Act of 1981 will work, if they are just given a reasonable period of time to work. The long-term benefits in jobs, economic growth, and government revenues will emerge, if they are given time to emerge. Faced with immediate short-term budget pressures, we recognize we are asking much of you. But we also firmly believe we are on the threshold of a new era of economic growth and strength for American industry.

In weighing the best course of action to decrease the federal deficit, it is vital that fundamental policy goals established last year not be sacrificed for minimal benefits and short-term gains. We believe that succumbing to the temptation to expand the minimum tax will achieve only limited political and revenue benefits at a disasterous long-term cost to the nation.

The Minimum Tax Coalition believes the Administration's minimum tax proposal is a poorly-timed policy reversal which will be highly damaging to key segments of American industry hardest hit by the present recession. It cripples hope for a quick economic recovery by these industries, effectively reverses important tax policies passed less than a year ago, and may well encourage trends toward overcentralization of U.S. industry. At the same time, the proposal will unfairly burden capital-intensive corporations during their reindustrialization effort, an effort which is absolutely vital if American industry is to continue to compete with, and ultimately overtake, its foreign competition.

We strongly urge that the Administration's proposal be defeated and that the existing minimum tax be repealed.

PARTICIPATING COMPANIES—THE MINIMUM TAX COALITION

Amax, Inc., Armco, Inc., Bethlehem Steel Corp., Cannelton Industries, Inc., Carbon Industries, Inc., The Cleveland-Cliffs Iron Co., CSX Corp., FMC Corp., The Hanna Mining Co., Inland Steel Co., Moore McCormack Resources, Inc., National Steel Corp., Pittston Coal Co., Republic Steel Corp., St. Joe Minerals Corp., Texasgulf, Inc., and Wheeling-Pittsburgh Steel Corp.

Mr. RUSSO [presiding]. Thank you very much for your testimony.

The gentleman from California, Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

Mr. Malott, one of the problems that you are faced with and we are faced with is a perception, whether it is accurate or not, that we are giving benefits to the rich at the expense of the poor, and major corporations are getting a big share of the tax breaks; but in many ways the corporate lifestyle seems pretty posh, and just to make corporate jets more accessible, I think, is a perception we face.

The Superbowl, for example, in Michigan had so many private jets arriving that weekend that the FAA had to set up a special system of reservations just to get landing clearances for somewhat over 1,000 arrivals in the airfields that could handle jets surrounding Pontiac.

Now, we got a list of those reservations from the FAA. It is very difficult because you have to go through an aviation code to figure who landed. We are only about a third of the way through the list, but at least two of your members had one, and one member had two planes in the area. Maybe they were not at the Superbowl, maybe they were on legitimate business, but I doubt it, and I think that a lot of distressed industries had planes up there that weekend.

I just bring it up because it is that kind of an image, just like it may be the tax break for Members of Congress that ruin it for the rest of the industry. Mr. Rangel asked the previous panel, is there anything really that business is willing to do to help us? It is always the other guy's ox that someone is willing to gore.

I have a feeling that in California we have a large amount of service and retail industries. They really do not benefit from the tax code of 1981 as the capital-intensive industries, although they may very well create more jobs on balance than the capital-intensive industries.

So I guess I am asking you the question that has been asked of the previous panel, which is: What areas do we change? I will give you the ridiculous extreme. In yesterday's testimony, Mr. Downey asked the whole panel: Would you rather retain safe harbor leasing or eliminate the corporate income tax altogether? Everyone said they would rather retain safe harbor leasing, just to give you an indication of how important they thought that was.

Mr. CONABLE. Those were all unprofitable companies paying no corporate tax at all.

Mr. STARK. They were paying no tax.

Mr. CONABLE. They were unprofitable in the sense that they did not have enough income to be subject to a corporate tax. So it is pretty obvious that under those circumstances, safe harbor leasing gives them a chance they otherwise would not have to raise money.

Mr. STARK. The Republicans have been backing losers for years. I understand that. [Laughter.]

Mr. CONABLE. I would not generalize about business from the group that we were talking to yesterday.

Mr. STARK. No, but why——

Mr. CONABLE. I will tell you. You should have asked the Roundtable people if they would rather have safe harbor leasing or the income tax reduction. You would have found that their group very strongly supports corporate income tax reduction.

Mr. STARK. One way to do it of course is to eliminate safe harbor leasing. Then we would have the money to reduce everybody's corporate——

Mr. CONABLE. Safe harbor leasing gives your service companies in California a chance to participate in a business tax deduction they otherwise would not have.

Mr. STARK. My service companies have pretty much rallied to the idea that they would rather get down as the Democrats proposed to a 34-percent corporate rate by doing away with the investment tax credit.

Mr. CONABLE. Sure, they are profitable.

Mr. STARK. No, I think profitable and unprofitable, because they will not stay in business very long unless they remain profitable—

unless the Government continues to bail them out like we bail out Chrysler. In other words, I am of a mind that we can let the losers go, and that free enterprise might gain a little efficiency if we let a few companies go under.

Mr. CONABLE. I apologize for interrupting the questioning. There was a question being asked here, and I did not mean to interrupt.

Mr. STARK. I wonder if Mr. Malott could suggest to us some areas in which business should participate in the belt tightening?

Mr. MALOTT. First of all, we have covered quite a bit in this discussion. I would like to indicate to you that FMC's airplanes were not at the Superbowl. I cannot speak for the airplane fleet policies of the people I represent before this committee.

If I am to stick to the subject that I have been asked to speak to, namely, capital accumulation for capital intensive industries—as opposed to covering the total waterfront of what business might contribute to our mutual problem—I would address the matter that you have mentioned several times this morning; namely, the service industries and comparing service industries with capital intensive industries.

You know, I think anyone who is in a capital intensive industry in an era when interest rates range anywhere above 8 or 10 percent has a very, very serious problem. A lot of those industries that are capital intensive have no alternative. If you are going to be in the business, it is capital intensive.

Therefore, we have been urging Congress, with some success recently, to address the whole matter of capital recapture. It does not apply to service industries. If you would give a businessman the alternative of being in a noncapital intensive business or a capital intensive one, most of them would select noncapital intensive. So I am saying to compare the two on this whole area of capital recapture is unrealistic.

Mr. STARK. Let us stay with capital industries, then. But then do you draw any distinction among the various capital intensive industries as in the best interest of a national policy?

Mr. MALOTT. Certainly. There are some more profitable than others.

Mr. STARK. How about some that will never be profitable, like steel mills on either coast?

Mr. MALOTT. I guess I am not prepared to agree or disagree with you on that. I am not sure whether the steel industry can or cannot be profitable.

Mr. STARK. Probably not. It is likely that inland steel mills, where they have water, fuel, ore, customers available, can compete and survive. Yet we have never dealt with that in Congress.

Let us take it outside of Congress for a minute. Would you support some kind of a national commission which at least ranked industries in this country in terms of their importance to us for national defense, creating jobs, and exporting into world trade, with the idea that we might do something like our trading competitors overseas and focus some of these tax subsides, which I am willing to do but only toward those companies where there is a chance of success, not to U.S. Steel to buy Marathon Oil. That gets us nowhere, it really does not.

Mr. MALOTT. I would think that in an effort to——

Mr. RUSSO. You may respond to the question, but the time of the gentleman has expired.

Mr. MALOTT. I would think if it were designed to truly develop national priorities it would probably be fairly worthwhile. I would not support, however, what I think you are concluding, that one of the purposes of the commission would be to select companies or industries that should be given special treatment.

I think that a commission which came out with some priorities in terms of things you are concerned about in the areas of national defense, exports, et cetera, then I think it could be very valuable in terms of establishing foreign policy and tax policy. But to do it selectively by industry, by company, I would disagree.

Mr. STARK. Thank you very much.

Mr. RUSSO. The gentleman from Pennsylvania, Mr. Bailey.

Mr. BAILEY. Thank you.

Mr. Malott, I will be very brief. I thank you for your testimony. I happen to agree with your point of view, your characterization of the alternative minimum corporate tax specifically.

One thing, I admire my colleague from California. But the issues concerning steel and its profitability, there is a great deal of misunderstanding about that. Steel, of course, in our system or worldwide, American steel would be just as competitive and can be just as competitive as steel anywhere.

The truth is that most systems place a preference and a very special preference on steel as a basic feedstock industry. They do it much more than we do. The thing is, steel is not even the best example, because really, if you look at the problems of capital-intensive industries generally, you are going to find there are preferences in the code that really do serve to support other types of economic endeavors in the country, frankly to the detriment of capital intensive industries.

We do not recognize their needs as much as most countries do, and there is a built-in neutrality in the code. Today's neutrality is tomorrow's distortion by virtue of the march of the history of technology. And that is really what brought us to this point in time today.

This point in time simply is that the distortions were not deliberately placed in the code have resulted in prejudice. For instance, look at the preferences on minimum tax that militate against, quite frankly, some of the preferences in our corporate code, that actually do work against the interests of our capital intensive industries. They have discouraged the formation of capital-intensive industries or they have encouraged them not to be competitive with investment priorities and investments in other countries around the globe.

It is not prejudicial to a particular sector. It is a recognition of the needs of the United States of America and, I might add, a service economy and a secondary manufacturing economy which also needs a little bit of security of supply and that sort of thing.

So we are talking about an integrated economy that needs proper recognition to all sectors, and the alternative minimum corporate tax, which quite frankly, first of all, is a misnomer—it is not a proper way to describe what it is and what it does.

I think we are slowly getting to the point in this country where, because of our concentration on the word "productivity," we are going to recognize what investment means. And I thank you.

No questions. Just a chance to get some things on the record. Thank you.

Mr. STARK [presiding]. Thank you very much, Mr. Malott.

The next panel—I might say while they are coming, Mr. Malott, I also oppose the minimum tax, only because it is a separate corporate tax system and we ought to change our present corporate tax system rather than build a parallel one that gets us all screwed up.

Mr. BAILEY. I told you I admired that gentleman, see.

Mr. STARK. Mr. Hahn, manager of government affairs, National Tooling & Machining Association; Wallace Woodbury, member, tax subcommittee, government affairs committee, International Council of Shopping Centers; Paul C. Fisher, president, Fisher Pen Co.; and Herbert J. Lerner, partner in charge of Washington tax services, Ernst & Whinney.

Mr. Hahn is not with us, I gather. Gentlemen, I believe you have all submitted prepared statements in the record in their entirety. I will ask you to proceed in the order in which you are on the witness list: Mr. Woodbury, Mr. Fisher, Mr. Lerner. You may summarize your statements in any manner that you wish.

Mr. Woodbury.

STATEMENT OF WALLACE R. WOODBURY, MEMBER, TAX SUBCOMMITTEE, GOVERNMENT AFFAIRS COMMITTEE, INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. WOODBURY. Thank you, Mr. Stark.

It would seem obvious to us in the shopping center industry that given the condition of the economy, it is certainly no time to further impair employment, capital outlays, and economic activity. We would like to refer specifically to two items in the President's recommendations; namely, construction period interest and the IDB provisions, which we believe will have this effect.

In regard to construction period interest, we note that section 1231 of the code specifically treats owning and operating of an income property as a business. Yet, section 189 denies deductibility of construction period interest to certain noncorporate taxpayers during the construction period, even though such interest and taxes are very real cash outlays, and actual cash expenses, not some sort of a hidden shelter. This discriminates against the real property business as opposed to other types of business.

The President recommended reducing the discrimination by extending section 189 to corporations. We feel it would be far better to eliminate the greater discrimination against a real property business as compared to another business by repealing section 189 altogether.

In regard to the tax on industrial development bond financing, the discussions that have been going on have been triggered, I believe, by some misconceptions as to revenue loss, some differences in testimony as to what the revenue impact might be, and also on what was perceived as horror cases or abuses of the use of the provisions.

We perceive shopping centers as an essential link in the production chain from manufacturer to distributer and onto the retailer. The shopping center makes a very real contribution to the economy of the local community and to the country. The contribution of a shopping center to the local tax base is very substantial and it is not limited to taxes on the income of the construction workers and the employment related to the creation of the center.

Our statistics show that shopping centers permanently employ one employee for every 400 to 500 square feet of gross leasable area. It is one of those few industries where many of those employees do not have to be skilled laborers. We provide a market for employment of people without particular skills, and to that degree our industry is unusual.

One center in which one of our members is using industrial development bonds involves 97,000 square feet and actually employs 240 persons full time. If you think of the spillover effect, of the 5-to-1 ratio of dependents to workers that is rather typical, that means our shopping center is supporting 1,200 people in the population of that community. It also provides essential services to the community.

We are working on another center in a county where there is no grocery store with more than 2,000 square feet of groceries in the entire county in this day and age of 40,000 foot supermarkets. That county has over 35,000 people, who have to commute an average of over 26 miles each way to buy groceries. The center that we are proposing to build there, and for which an inducement resolution has been granted, provides very necessary services to those people.

As far as the Federal tax impact of industrial development bonds we refer in our testimony to Dr. Ture's study that you have had before you before, done in 1980, and also to the study by Kormendi and Nagle in 1981 which both disagree substantially with the CBO's projection on the revenue impact.

We think the direct revenue impact on the Federal Government is minimal, besides all the satellite benefits to the local community. The ICSC is satisfied that a legitimate cost-benefit analysis considering all the issues relevant to impact on the national economy would dictate not only a preservation of the current use of industrial development bonds but an expansion of the tax-exemption program.

Moreover, we point out that imposing new limitations at this time of extraordinarily high interest rates will freeze out new entries into the industry and reduce employment and the uses for manufactured products and further depress the construction and real estate industries.

Communities have widely divergent reasons for determining when to issue revenue bond approvals. Since we believe that the interest of the Federal Government is minimal, we believe that it is far better not to impose uniformity but to leave those decisions to the local communities.

With respect to the President's specific recommendations, we support the idea of requiring a local elective official or legislative body to vote on the bond. We support the public hearing concept, and the idea of annual reports. We believe that reporting is desirable so that relevant data is available on which to evaluate the tax

impacts of industrial development bonds, especially since the data that is available currently is skimpy.

We are convinced that some amendments to the law should be made in terms of the eligibility of certain facilities for industrial development bond financing to eliminate what some have perceived as abuses. We support the Metzenbaum approach to limiting the application of these activities, to eliminate those particular things that some have perceived to be disadvantageous.

We are concerned that certain of the other proposals of the administration would deny local communities the benefits of much-needed facilities including, particularly, the requirement of a local contribution which imposes a burden on those hard-pressed communities least able to meet the contribution.

Recently the ICSC surveyed 11 of its members as to the effect of the small-business limitation proposed by the President upon shopping center construction and operation. The members reported that the limitation would effectively prohibit the traditional anchor stores—such as grocery and drug stores of small and medium shopping centers from locating.

We believe the purpose of these bonds is not to help the developers, but to help create facilities, produce jobs and necessary community amenities and services, and improve the tax base. We also believe that the stronger the anchor tenants, the more viable these centers are and that to restrict, on the basis of size, stronger businesses will do the most damage to the remaining small businesses because they would be denied the viable anchor stores required to attract the traffic and business necessary for the success of a shopping center. Thus, we believe that it would be counterproductive to impose a size limitation.

We think the present arbitrage provisions are adequate. To further expand the arbitrage provisions creates real problems, because those funds must be escrowed and the cost of the escrow should certainly be a legitimate cost in determining arbitrage limitation.

Finally, we believe that IDB financing today provides the only escape valve that permits development notwithstanding the prevailing high interest rates that are around. Restricting IDB's at this time would merely frustrate the economy and discourage further development.

I might comment, although I know Mr. Moore is not here, that I can speak from firsthand experience in response to the question he posed about the necessity of IDB financing. The majority of the projects I am familiar with that have been financed with IDB's in the shopping center industry in the last 2 or 3 years would not have been developed without that type of financing available, because the tenants just will not pay enough rent to make such projects feasible. In our testimony we gave some examples of that impact on a couple of centers that were actually built—although the statistics are several years old when the rates were 3 to 4 percent below where they are right now.

Thank you, Mr. Stark.

[The prepared statement and additional comments follow:]

STATEMENT OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

SUMMARY OF STATEMENT

The members of the International Council of Shopping Centers (ICSC) believe that the current economic downturn requires the adoption of tax and economic policies which encourage and promote investment. The need for such policies is particularly acute in the real estate industry. The ICSC, therefore, urges that the proposal to restrict industrial revenue bond financing and the proposal to expand the limitations upon the deductibility of construction period interest and taxes be rejected and the current limitations upon the deductibility of construction period interest and taxes be repealed.

The ICSC maintains that IRB financing causes little, if any, net federal revenue loss while generating substantial federal, state and local income, sales and real estate taxes through the development, construction and operations of retail sales facilities.

Construction period interest is a legitimate business cash outlay and should be treated like other expenses of business. It is discriminatory to single out construction period expenses by denying deductions which are accorded all other business expenses.

I. Introduction

The International Council of Shopping Centers (ICSC) is a business association of approximately 10,000 members. These members are shopping center developers, owners, operators, tenants, lenders and others engaged in related business enterprises. ICSC represents a majority of the 22,000 shopping centers in the United States.

It is estimated that more than 5.9 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction. The rippling effect of shopping center development on employment in related businesses, including display advertising, maintenance and cleaning, legal and accounting, and the production and transportation of goods sold in the centers, is considerable.

II. Economic benefits of shopping center development

The extent of the contribution of shopping center development to the nation's productivity is not fully understood. Many people think of productivity solely in terms of the process leading directly to the manufacture of goods. Others would broaden the concept to include the distribution of those goods to the loading docks of the nation's retail facilities--but not to the distribution of products to the ultimate consumer. The fact is, of course, that retail facilities, as the final link in the chain of distribution, are an integral part of the productive process. Thus, to deny tax benefits to retailers but provide them to manufacturers or distributors is self-defeating and inconsistent since, without retail facilities, there can be no expansion of other links in the economic and production chain.

A. *Employment.* Shopping centers generate new jobs and secure existing jobs in a number of ways which represent tangible benefits to the community. Of course, the construction of a center provides employment to all sectors of the building trades. In addition, the ICSC has estimated that the tenants of shopping centers employ one full-time employee for every 400 to 500 square feet of gross leasable area space. Thus, a typical neighborhood or community shopping center of 175,000 square feet anchored by a soft goods store and a supermarket employs between 350 and 435 people. Moreover, many of these people, as recent entrants into the job market, would have been unemployable or marginally employable in industrial positions.

The increase in employment generated by shopping center development ripples through the local community as other businesses open or expand to provide the services for the new employees. Each new opening or expansion creates, in turn, new jobs and additional revenues.

B. *Tax Revenues.* It is difficult to dismiss the economic impact of shopping center development in local communities when one looks beyond abstract projections of sales and property tax revenues and considers the empirical data on the actual performance of shopping centers. Sales taxes and real property taxes are two of the largest sources of state and local revenue attributable to shopping centers. Other direct contributions to local treasuries include business license revenues and personal property taxes on such things as office and retail equipment and inventories.

For example, a 1975 study published by ICSC included a twelve-year case history of the fiscal impact of a large shopping center in Oak Brook, Illinois. The Oakbrook Regional Shopping Center is no more typical of the diverse facilities developed by

ICSC members than any one shopping center can be. Nevertheless, the Oakbrook study suggests generally the powerful fiscal influence shopping centers can exert.

During the period from 1963 through 1973, the Oakbrook shopping center was the primary source of sales tax revenue for the Village of Oak Brook, Illinois. The shopping center's share of total municipal revenues ranged from a high of 91.3 percent in 1965 to 75.4 percent in 1973 (the last year for which the study developed data). Even after taking into account the very modest increase in municipal tax expenditures attributable to the shopping center's presence in Oak Brook (for example, increased police and fire protection and local road maintenance), the ICSC study found that in 1973 Oak Brook received net cash-flow benefits in excess of $1.2 million directly attributable to the shopping center. Without this net revenue source, the report concludes that Oak Brook would have experienced a deficit requiring either a decrease in expenditures or another income source. In fact, the local tax revenue generated by the shopping center allowed Oak Brook to maintain services without imposing a property tax for a number of years.[1]

III. Construction period interest and taxes—IRC section 189

Section 189 of the Internal Revenue Code, enacted by the Tax Reform Act of 1976, requires that a taxpayer other than a corporation (which is not a subchapter S corporation or a personal holding company) capitalize real property construction period interest and taxes. The amount capitalized may be amortized over a 10-year amortization period which was phased in and becomes fully effective as to commercial and industrial property in 1982 and as to residential property in 1984. Thus, although this provision has already had an adverse effect upon the real estate industry, the full impact of the provision has not yet been fully felt.

A. *Capital Formation.* The current law has the effect of draining capital from the real estate industry since interest and taxes are real, out-of-pocket expenses which have to be paid whenever due. By forcing individuals who develop real estate to capitalize these actual business expenses rather than allowing them to deduct them currently as others are allowed to do, section 189 diminishes the capital available for the development of real estate.

In addition, Section 189 is highly inflationary because, by increasing the capital required it increases the cost of development, and those who wish to construct a property must either abort the project or recover this increased cost of development through higher rents to lessees and higher prices to purchasers. In addition, businesses who lease, or who construct their own facilities, will pass these costs on to consumers through higher prices.

B. *Equity.* Section 189 is especially harmful to new and/or not-so-wealthy entrepreneurs, who do not have large amounts of capital and who must raise additional capital as a result of this provision. This burden is especially onerous at current high interest rates. Consequently, these entrepreneurs are discouraged or prevented from entering into otherwise viable housing and other real estate developments or constructing new or expanded facilities for their businesses. Thus, Section 189 discourages competition and increases prices.

Repeal of section 189 will merely allow a dollar-for-dollar deduction of amounts actually paid as interest and taxes during the construction period, which is the time when capital is most needed, and will equalize the treatment of interest and taxes, which are actual out-of-pocket expenses, between real property business expenses and all other business expenses, none of which is subject to this onerous provision. The tax code currently treats the income from real property investments as business income, and it is inequitable to deny expense treatment to the costs which generate that income.

C. *Recommendations.* The administration has proposed extending this investment disincentive to all corporate taxpayers. In light of the adverse consequences which section 189 now has on most real estate development, we support the repeal of section 189 retroactive to its original effective date. Repeal of section 189 will equalize the treatment of interest and taxes, which are actual out-of-pocket business expenses, between the real estate industry and other business endeavors. Repeal also would remove the discrimination created by imposing this section against individuals and not against corporations which construct real property. Most importantly, repeal will encourage investment in productive real property, encourage expansion of current retail and manufacturing plant, and reduce rents.

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[1] Levin, Measuring the Fiscal Impact of a Shopping Center on its Community," p. 30; International Council of Shopping Centers, 1975.

IV. Industrial revenue bonds (IRBs)

A. *Role of IRBs in Shopping Center Development.* As with other construction industries, shopping center development has in the past been dependent upon financing at rates which are consistent with affordable rents. Present market conditions have by and large dictated what we hope will prove to be a temporary end to conventional financing and, therefore, a temporary end to conventionally financed shopping centers.

The ICSC submits that the availability of industrial revenue bond financing, with the limited tax exemption afforded under Internal Revenue Code S103(b), has allowed shopping centers and other commercial and industrial facilities to be built in communities that would otherwise remain without the clear social and economic benefits directly attributable to those facilities.

IRB financing has been crucial to the development of small- and medium-sized shopping centers of up to 200,000 square feet of gross leasable area. These are the centers which represent the commercial heart of countless communities throughout the country, and they would have gone unbuilt but for the capital resources made possible (or at least more accessible) through IRB financing. The ICSC believes that the communities served by these facilities are economically better off today than they would have been without them. For example, in 1979, ICSC member M. H. Hausman Co., an Ohio developer of commercial facilities, built two shopping centers with industrial revenue bond financing. The company reports that neither of these facilities would have been built if the sole financing method available to the company had been conventional mortgages at prevailing interest rates.

Although the IRB and conventional rates have risen 3 to 4 percent since the facilities were built, a review of the income and expenses associated with one of M. H. Hausman's shopping centers illustrates the critical importance of IRB financing. The company's Columbia-Detroit shopping center in Westlake, Ohio, comprising some 50,000 square feet of gross leasable area, was financed through a $2 million IRB mortgage bearing an interest rate of 7½ percent.

As figure 2 shows, the annual debt service of $181,632 on the mortgage, combined with general and miscellaneous expenses, yields a net annual cash flow to the shopping center owner, after deduction from rental income, of $34,197. A 14-percent mortgage, on the other hand, would result in an annual debt service of approximately $289,000. That mortgage expense would, even with all other expenses remaining the same, produce an annual loss in excess of $74,000, and would, therefore, have dictated that the Columbia-Detroit shopping center not be built.

FIGURE 2

	IRB financing	Conventional mortgage financing
Income—fixed rent	$220,176	$220,176
Expense:		
Mortgage	[1] 181,632	[2] 289,000
General expense-net recovery	3,800	3,800
Miscellaneous expense	2,400	2,400
Total	187,832	295,200
Net cash flow (loss)	34,197	(74,824)

[1] $2,000,000 principal amount, 7½ percent interest, 24 year term.
[2] $2,000,000 principal amount, 14 percent interest, 25 year term.

A similar analysis of income and expenses for the second of M. H. Hausman Co.'s IRB-financed projects reflects the same devastating effect of high mortgage interest rates. The Crossroads Plaza in Saybrook, Ohio, had more than 70,000 square feet of gross leasable area, and produced a net cash flow of $39,358. If M. H. Hausman Co. had been unable to obtain the 7½ percent IRB-backed mortgage available at that time and been forced to proceed at the prevailing 14 percent mortgage rate, the positive cash flow would have been transformed into a net loss of $115,442 per year.

Of course, it might be argued that these illustrations show nothing more than that present market conditions justify higher rents to offset a developer's rising mortgage costs. As a practical matter, however, tenants of retail facilities are strictly limited in their ability to bear the burden of increased financing costs.

In deciding whether or not to lease space in a proposed shopping center, prospective tenants invariably focus on their projected return on investment. Although

methods vary from one retailer to the next, analyses of returns on investment consider such factors as the estimated sales in the proposed facility, the expense of doing business, the anticipated profit, and a comparison of that profit to the total investment to be made in the new facility.

Clearly, rent is an important component of a tenant's expense of doing business. Thus, a proposed shopping center that cannot keep lease payments within the range required by a prospective tenant's return-on-investment analysis will not get built or will be delayed until interest rates fall to a level that will allow for rents which will permit the retailer to operate at a profit.

In the interim, people who could have been working will not be working, personal and business income taxes that could have been collected will not be collected, state and local taxes that could have been collected will not be collected, manufactured goods that would have been purchased and used will not be purchased, and so on.

The ICSC believes that these illustrations demonstrate that the net effect of eliminating or reducing the availability of small-issue IRB financing for retail facilities will be a substantial reduction of new construction starts in retail facilities. Concomitant with that reduction will be the loss to local treasuries of significant tax revenues. For example, the two relatively small shopping centers built by M. H. Hausman Co. discussed above are expected to generate total combined real estate and sales taxes of approximately $67,000 per year at full occupancy. Of course, that $67,000 is calculated without regard to the very significant local revenues arising out of increased employment (estimated at 240 to 300 new jobs) and the secondary development that may be spurred by the introduction of the new retail facilities.

B. *Limitation Upon Certain Uses of Small Issue IRBs.* As previously indicated, any distinction between commercial and industrial uses of IRBs is counterproductive. Without a viable and healthy network of retail plant, no increase in manufacturing capacity will occur. Each segment of the economic system is interconnected and inadequate plant in one segment causes bottlenecks and blockages that ripple through the entire system.

The ICSC believes that IRB financing of shopping centers and other retail facilities contributes as much or more to both the economic wellbeing and quality of life of a community as does IRB financing of other links in the industrial and distribution chain.

For example, figures compiled by the New Jersey Economic Development Administration demonstrate that, at least in that state, IRB financing for commercial projects is a more effective means of creating permanent jobs than all other uses of IRB financing. As figure 1 indicates, the number of permanent jobs created per $1.0 million of industrial revenue bond financing for commercial projects (including retail facilities) was approximately one-third higher than the number of industrial jobs generated by the same dollar amount of IRBs.

FIGURE 1

[Dollars in thousands]

Project type	Total new jobs [1] 1980	Total 1980 industrial revenue bonds issued in support of projects	New permanent jobs per $1 million of IRB's
Commercial (including retail)	1,613	$52,181.1	30.9
Balance of projects, excluding office and investment in quasi-public utilities	11,131	478,334.4	23.3

[1] Permanent (excludes construction).

Source: New Jersey Economic Development Administration, 1980 Annual Report 15–21.

C. *Federal tax revenue impact of small-issue IRB financing.* The Department of the Treasury projects future revenue gains as a result of its proposal to limit IRB financing, although even the Treasury projects a net revenue loss in fiscal 1983. ICSC suggests that the results of a 1980 study conducted by Norman Ture, currently Treasury Undersecretary for Tax and Economic Affairs, more accurately states the effect of such limitations.

Ture pointed out that assumptions such as those made by the Department of Treasury are unrealistic since they presume that there are no changes in economic activity in response to the tax change. Thus, they erroneously assume that the volume of private investment would be unaffected by eliminating the IRBs because

each eliminated dollar of IRB-financed investment would be replaced by a dollar of taxable financed capital outlay.

However, if the amount of IRBs were deemed to be associated with additional investment—that is, with investment which otherwise would not be undertaken—the initial impact revenue effect would be zero, since no displacement of other financing would have occurred. Taking into account changes in economic activity in response to the tax change and the effects of these changes in the economy on tax bases, additional IRB financing results in net additions to the volume of capital formation, rather than displacement of taxable financed investment.

Clearly, the experiences of ICSC's membership bear out Dr. Ture's conclusion that "IDBs are productive instruments for promoting economic development by making saving and investment more attractive to individuals and businesses. Their use results in overall gains in capital formation, employment, and output, rather than merely changes in the location of economic activity." [2]

The Congressional Budget Office ("CBO") also has projected additional federal tax revenues through the elimination of small-issue IRB financing. However, in testimony before the House Ways and Means Subcommittee on Oversight delivered on April 8, 1981, Roger C. Kormendi of the University of Chicago challenged certain assumptions upon which the CBO based its estimates of the net loss to the federal treasury associated with IRBs. Kormendi, in a report prepared with Thomas T. Nagle, concluded that the cost of IRB financing in lost federal tax revenues is $4 to $6 million for each billion dollars of new IRBs when taxable interest rates are between 10 percent and 14 percent. Kormendi's estimates contrast sharply with the CBO's estimates of $30 to $40 million for each billion dollars of bonds.[3]

Furthermore, Kormendi estimates that each dollar of interest saving for IRB borrowers costs the U.S. Treasury approximately 15 cents in federal tax revenues. Thus IDBs are more than six times as efficient as direct subsidies, which cost the U.S. Treasury one dollar for each dollar of benefit. This conclusion contrasts sharply with the Treasury's claim that each new dollar of interest saving for IDB borrowers costs the U.S. Treasury $1.33 in federal tax revenues.[4]

It is important to note that these estimates of revenue loss are not, as Ture would say, "net-of-feedback." Kormendi points out that tax revenues depend not only on tax rates but also on the tax base. Since anything that encourages the tax base to expand will result in a higher feasible level of tax revenues in the future, the lower capital cost provided by the interest tax exemption will almost certainly lead to more investment and growth of the small business sector. Therefore, sales, property, and income tax revenues will grow.

D. *Evaluation of Small-Issue IRB's.* The ICSC suggests that any decision to preserve or eliminate the tax exemption for small-issue industrial revenue bonds should be made solely on economic merit. The ICSC membership is satisfied that a legitimate cost-benefit analysis, considering all issues relevant to ultimate impact on the national economy, would dictate not only the preservation, but the expansion, of the present tax exemption.

If it is correct that minimal or no net loss to the federal treasury arises from the availability of small-issue IRB financing, no other legitimate policy consideration would be served by curtailing access to that source of capital. At the very least, it would be inappropriate for IRB critics to pursue some hidden philosophical goals, whatever those may be, disguised as a legitimate effort to reduce federal budget expenditures.

Moreover, the ICSC points out that imposition of new limitations at this time of extraordinarily high interest rates freezes out new entrants into the real estate industry, diminishes employment, and reduces markets for manufactured products. The ICSC suggests the American consumer and the real estate industry will both benefit by encouraging new development rather than by discouraging it.

In addition, the CBO's recent study reflects the diverse criteria among states for the appropriate uses of IRBs within their borders. So long as the federal interest in governing IRB use is as minimal as the net effect of IRBs on the federal treasury, ICSC believes that the federal government should decline to engage in efforts to impose uniformity on the states' exercise of their authority to issue IRBs. If individual communities and states, as major benefactors of the increased revenues attribut-

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[2] N. Ture, A Report Prepared for the National Committee on Small Issue Industrial Development Bonds: Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Bond Provisions 11 (1980).

[3] R. Kormendi and T. Nagle, A Summary of the Nature and Effect of Small-Issue Industrial Development Bonds 1 (1981).

[4] Id.

able to commercial development, choose to encourage particular types of commercial and industrial development, their will need not and should not be supplanted.

E. *Recommendations.* It is clear, both from the CBO's acknowledgment of the inadequate data underlying its recent report and from the ICSC's own efforts to develop comprehensive information on the use of IRBs, that Congress cannot now be fully informed on the economic merits of IRB financing. The ICSC, therefore, recommends that reporting requirements be imposed at the state level on all users of industrial revenue bonds.

With respect to the specific proposals of the Administration, ICSC supports the requirement that a local elected official or legislative body approve the issuance of a bond and the requirement of a public hearing prior to such issuance. In addition, ICSC suggests that annual reports be required containing information on the amounts of IRB financing provided; the number of jobs created per million dollars of IRB issuance; wages, FICA taxes, and federal, state and local income taxes associated with these jobs; and property taxes and sales taxes generated by IRB-financed projects. ICSC is also prepared to meet with Members of Congress and the Department of Treasury to discuss excluding from IRB financing certain offensive uses.

The ICSC strongly believes that denying IRB financing to larger businesses totally misconceives the function of IRBs. They are not a subsidy to the developer or user but are intended to provide a community with economic development, increased jobs and tax revenues it would otherwise not enjoy. No matter how big or financially secure a corporation is, it has no incentive to invest in a particular community unless the deal will show a profit. IRBs are necessary to make the deals work in many communities, particularly those most in need of increased employment.

ICSC is very concerned, however, that the effect of other administration proposals will be to deny local communities the benefits of much needed facilities that depend upon IRB financing. In particular, the requirement of a local contribution imposes a financial burden on those hard pressed communities most in need of new investment. Similarly, the proposed small business limitation, to the extent it reduces investment and development, deprives local communities of the benefits of new investment.

Recently, the ICSC surveyed eleven of its members as to the effect of the small business limitation upon shopping center construction and operation. The members reported that the limitation would effectively prohibit the traditional anchor stores of small and medium shopping centers—groceries and drug stores—from participating in an IRB financed facility. Thus, communities would be the ultimate losers of such a limitation.

The requirements that facilities financed by tax-exempt bonds use straight line cost recovery methods and extended recovery periods for purposes of computing earnings and profits is particularly damaging since it substantially reduces the yield on investment to a degree which may make the entire project unfeasible. Finally, ICSC suggests that the arbitrage limitations and registration requirments result in additional and unnecessary costs to the developer and, with respect to the arbitrage limits, further suggests that the current law is adequate.

We generally recommend that the relative benefits of IRB financing are so great that Congress should encourage increased use of IRBs, whether through raised capital expenditure limits or other means, to finance commercial and industrial projects. ICSC submits that certain provisions of Internal Revenue Code section 103(b) have imposed inequitable and unnecessary conditions on the availability of IRB financing. The current $10 million capital expenditure limit applies, under section 103(b), to all facilities that are located in the same municipality or county and associated with the same principle user or users.[8] The jurisdictional limitation of section 103(b) should be modified to allow additional capital expenditures for industrial or commercial projects in areas where higher population would suggest a greater demand for those projects. The ICSC recommends, therefore, that the Congress respond to the needs of those populous communities by permitting higher capital expenditure limits in jurisdictions where population levels exceed a specified level.

Finally, it is a particularly bad time to consider restricting the use of IRBs. All agree the economy is in a very serious recession and that the major program the Government has proposed to end the recession is increased investments from the private sector. Unfortunately, this plan is not working, and the President has identified high interest rate as the reason. IRB financing offers the only escape valve that permits some development to continue at below market interest rates. In many places, IRB financing is "the only game in town." Restricting IRBs at a time when

[8] I.R.C. Sec. 103(b)(6)(E).

high interest rates are frustrating the economic recovery plan will serve only to worsen and prolong the recession.

ADDITIONAL COMMENTS OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS—BUSINESS ENERGY PROPERTY INVESTMENT TAX CREDITS

Section 46 of the Internal Revenue Code, enacted by the Energy Tax Act of 1978 and modified by the Crude Oil Windfall Profits Tax Act of 1980, provides additional tax credits for investment in conventional and unconventional classes of energy property. The credits for conventional energy conservation technologies are scheduled to expire on December 31, 1982, and the credits for unconventional energy conservation technologies are scheduled to expire on December 31, 1985.

A. *Specially Defined Energy Property.*—Although the business community has made significant progress in recent years to reduce energy consumption, energy conservation remains a major and essential national priority. The need for incentives is clearly related to the continued price controls imposed upon natural gas. However, even the decontrol of all energy sources would not eliminate the importance of investment incentives for energy conservation property. Such incentives merely correct the investment disincentives which have become imbedded in the economy through past price and allocation control as well as unfavorable tax policies.

Commercial buildings and facilities, including shopping centers, are in particular need of energy tax credits as a result of the denial of such credits by the IRS for such energy property as automatic energy control systems. These systems produce major energy savings by substantially increasing the efficiency of heating and cooling equipment yet the IRS refuses to permit use of the credit in commercial buildings based on an excessively restrictive interpretation of the Code—an interpretation clearly not supported by the legislative history of the Energy Tax Act.

B. *Recommendations.*—The Administration has proposed to repeal the credit for all energy property—both conventional and unconventional—on December 31, 1982. ICSC suggests that extension and expansion of the business energy credits is necessary to maintain the progress toward conservation which has occurred. Specifically, ICSC urges that Congress make clear that specially defined energy property is eligible for this credit when installed in connection with commercial and retail space, that the conventional credits be extended through 1986, and that the credit be increased from 10 to 20 percent. H.R. 4912, the Commercial Business Energy Tax Credit Act, which is now pending in this Committee, would accomplish these objectives. The ICSC urges that the provisions of this bill be enacted.

Mr. STARK. Thank you very much for your testimony.

Our colleague, Congressman Santini, who has joined you at the table, is going to introduce his constituent. Jim?

Mr. SANTINI. Thank you, Mr. Chairman, members of the committee.

It is a pleasure for me to introduce to this committee one of the extraordinary citizens in Nevada, a State that is renowned for its extraordinary residents. Mr. Fisher is a scientist, an engineer, an economist, a dynamic small businessman who has turned into a big businessman. Members of the committee will immediately identify with the Fisher Pen, as the astronauts did and many others in this country who have used the genius and the facility for invention of Mr. Fisher, and in other arenas as well.

It is a pleasure for me to introduce to this committee one of the extraordinary citizens of not only the State of Nevada, but the United States of America, Mr. Paul Fisher.

Mr. STARK. Welcome to the committee, Mr. Fisher, and we look forward to your testimony.

STATEMENT OF PAUL C. FISHER, PRESIDENT, FISHER PEN CO.

Mr. FISHER. Thank you, Jim, and Mr. Chairman. I appreciate this opportunity very much.

I am told I have 5 minutes to save the world.

I am the first real scientist in the field of economics. I am here to explain to this committee how you can apply the scientific technique to our tax problems so that this Nation can survive.

I first learned to apply the scientific technique to machines, chemicals, and things like ball pens. It is the only technique that can successfully solve any problem of any type in any field. It has been proven in the physical sciences by creating jet planes, space travel, television, computers, and the many other wonders of this marvelous scientific age.

Together, we can successfully apply the scientific technique to America's economic problems, with some astounding results. The scientific technique is simple to use, if we are able to admit and accept our ignorance and not try to hide that ignorance behind some phony theory. The scientific technique requires the ability to learn and to use accurately the facts that experience can teach us.

The key is objectivity and complete accuracy. No one ever got the correct answer to any problem without accuracy. We will solve America's problems when we put aside our pet theories and prejudicies and deal strictly with a few proven facts that we can learn from experience.

Economics as taught today is not a science, because those who teach it have neglected the basic fundamentals. Today's economists deal largely with interest rates, the gross national product, the rate of inflation, supply and demand, the stock exchange, the banks and other business organizations.

To be a true scientist in economics, we must first be philosophers, because we have to decide what is important and where we want to go. I cannot tell you what your goals are, nor what they should be. But as for myself, I know I am primarily concerned about what is happening to the American people.

My goal is the happiness, the health, the security, the progress, and the survival of the American people. The most important thing in the world, the most sacred thing in the world, is a human being. His life, his happiness, his progress, is my concern. Organizations have no value within themselves and are directly valuable only when they help people.

If you share my views, then let us look at our tax laws with this in mind. If a human being is the most important thing in the world, why do we discriminate against people by taxing them at a higher rate than we tax organizations? A corporation does not have to pay income tax unless it makes a profit, but a human being may not be earning enough to pay his necessary room and board, yet we take 15 to 30 percent of his paycheck away before he even gets it.

Our Government is actively training people not to work by penalizing those who work and rewarding those who do not. The payroll tax also punishes those who hire and create jobs. This reduces the number of jobs available and adds directly to the unemployment problem.

Are we or are we not concerned with people: Their security, their rights, their freedoms, their happiness, and their opportunities? The opportunity to work constructively for a liveable wage is man's most sacred right. That opportunity has been destroyed for millions of Americans by our Government through its unfair tax laws,

which discriminate unjustly against those who work or need to work for a living, and also against those who hire and create jobs.

This is the major cause of unemployment. Unemployment and underemployment cause intolerable human suffering. They are the major cause of our increasing crime rate. When we deprive a man or a woman of the opportunity to do constructive work, we destroy his life, take away its meaning, and sometimes drive him to crime. Welfare or charity is no substitute for an opportunity.

Unemployment and underemployment are now destroying the happiness and ruining the lives of millions of Americans, fostering a crimewave that is a threat to everyone.

The major cause of unemployment today is our terribly unfair income tax laws, including the payroll taxes, which are the worst of all. The income tax is counterproductive. It destroys incentive. It tends to depress the economy, lowering the tax base and thereby increasing the deficit.

Experience has proven that we can never balance the budget by increasing our income taxes, particularly the payroll taxes, which have gone up, not down, under this present administration. We desperately need a substitute for the income tax.

Some have suggested additional excise taxes, a value added tax or some other kind of sales tax. Sales taxes are also counterproductive, because they tend to slow down the sale of goods. They are directly the most inflationary of all taxes. We do not need more inflation and we do not need the Government forcing an increase in prices, which slows the turnover of goods, depressing the economy and adding to unemployment problems.

So what can we tax? Our Government is in deep economic trouble. Sure it should cut expenses. But it also needs to raise enough money to live within its means. Deficit financing is a time bomb and that bomb is already beginning to explode.

What shall we tax? How can the Government raise the necessary funds that it absolutely requires? We have eliminated the tax on incomes and the tax on sales. The only practical thing left to tax is assets.

America is the richest nation in the world, with over 6 trillion dollars' worth of assets that are now largely untaxed. But since the prosperity and the economic security of our people requires a wide distribution of buying power, those people with few assets should be taxed very lightly or not at all.

I suggest a graduated tax on assets. The more assets, the higher the tax rate, exempting the first $200,000 worth of assets owned or controlled by any individual or any organization.

I suggest that all assets—land, buildings, machinery, inventory, cash, accounts receivable, notes, deposits, stocks, bonds, and any and everything else of value—be taxed on as equal a basis as practicable, with no credit allowed for liabilities. I suggest that all organizations and all individuals be taxed equally at the same rate, without any discrimination.

I believe that such a revolutionary tax program can balance the budget, pay off the national debt, stop inflation, reduce unemployment, give us a new birth of freedom, restore prosperity to our people, and make America again the land of opportunity.

Mr. STARK. Thank you very much, Mr. Fisher.

[The prepared statement follows:]

PAUL C. FISHER'S APRIL 1, 1982 STATEMENT BEFORE THE COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES

Chairman Rostenkowski,
Ladies and Gentlemen:

I am Paul Fisher. I represent only myself. I thank you for this opportunity.

I am a successful small business man, accountant, engineer and the inventor along with my associates of the pressurized ball pen used by our Astronauts in Outer Space. My patent also covers the popular new erasable ink pens.

I first learned to apply the scientific technique to machines, chemicals, and things like ball pens. It is the only technique that can successfully solve any problem of any type in any field. It has been proven in the physical sciences by creating jet planes, space travel television, computers and the many other wonders of this marvelous scientific age.

I believe, that together we can successfully apply the scientific technique to America's economic problems with some astounding results.

Let us try.

The scientific technique is simple to use, if we are able to admit and accept our ignorance and not try to hide that ignorance behind some phony theory. The scientific technique requires, only, the ability to learn and to use, accurately, the facts that experience can teach us.

The key is objectivity and complete accuracy.

No one ever got the correct answer to any problem without accuracy.

We will not solve America's problems until we put aside our pet theories and predudices and deal strictly with the few proven facts that we can learn from experience.

Economics as taught today is not a science because those who teach it have neglected the basic fundamentals. Today's economists deal largely with interest rates, the gross national product, the rate of inflation, supply and demand, the stock exchange, the banks, and other business organizations.

To be **true scientists** in economics, we must **first** be philosophers, because we have to decide what is important and where we want to go.

I cannot tell **you** what your goals are, nor what they should be - - but as for myself, **I know:**

I am, primarily, concerned about what is happening to the American people. My goal is the happiness, the health, the security, the progress, and the survival of the American people.

The **most important,** the most sacred thing in the world is a **human being.** His life, his happiness, his progress is my concern.

Organizations have no value within themselves and are indirectly valuable, only, when they help people.

If you share my views, then let us look at our tax laws with this in mind.

If a human being is the most important thing in the world, why do we discriminate against people by taxing them at a higher rate than we tax organizations?

A corporation doesn't have to pay an income tax until it makes a profit. But, a human being may not be earning enough to pay his necessary room and board, yet we take 15 to 30 per cent of his paycheck away even before he gets it.

Our Government is actively training people not to work by penalizing those who work and rewarding those who don't.

The payroll tax, also, punishes those who hire and create jobs. This reduces the number of jobs available and adds directly to the unemployment problem.

Are we or are we not concerned with people, their security, their rights, their freedoms, their happiness and their opportunities?

The opportunity to work constructively for a livable wage is Man's most sacred right. That opportunity has been destroyed for millions of Americans by our Government through its unfair tax laws which discriminate, unjustly, against those who work or need to work for a living and, also, against those who hire and create jobs. This is the major cause of unemployment.

Unemployment and under-employment cause intolerable human suffering. They are **the major cause** of our increasing **crime** rate.

When we deprive a man or a women of the opportunity to do constructive work, we destroy his life, take away its meaning and sometimes drive him to crime. Welfare and charity is no substitute for an opportunity.

Unemployment and under-employment are now destroying the happiness and ruining the lives of countless millions of Americans, fostering a crime wave that is a threat to everyone.

The major cause of unemployment, today, is our terribly unfair income tax laws, including the payroll taxes which are the worst of all.

The income tax is counter-productive. It destroys incentive. It tends to depress the economy, lowering the tax base and, thereby, increasing the deficit.

Experience has proven that we can never balance the budget by increasing our income taxes, particularly the payroll taxes which have gone up, not down under this present administration.

We desperately need a substitute for the income tax.

Some have suggested additional excise taxes, a value added tax or some other kind of sales tax. Sales taxes are also counter-productive because they tend to slow down the sale of goods. They are directly the most inflationary of all taxes. We don't need more inflation and we don't need the Government forcing an increase in prices which slows the turnover, depressing the economy and adding to the unemployment problem.

So, what can we tax? Our Government is in deep economic trouble. Sure, it should cut expenses, but it also needs to raise enough money to live within its means. Over fifty years without a balanced budget. Deficit financing is a time bomb and that bomb is already beginning to explode.

What shall we tax? How can the Government raise the necessary funds that it absolutely requires?

We've eliminated the tax on incomes and the tax on sales. The only practical thing left to tax is assets.

America is the richest nation in the world with over six trillion dollars worth of assets that are now largely untaxed.

But, since the prosperity and the economic security of our people requires a wide distribution of buying power, those people with few assets should be taxed very lighly or not at all.

I suggest a graduated tax on assets — the more assets, the higher the tax rate — exempting the first $200,000 worth of assets owned or controlled by any individual or any organization.

I suggest that all assets (land, buildings, machinery, inventory, cash, accounts receivable, notes deposits, stocks, bonds and any and everything else of value) be taxed on as equal a basis as practical with no credit allowed for liabilities.

I suggest that all organizations and all individuals be taxed equally at the same rate without any discrimination.

I believe, that such a revolutionary tax program can balance the budget, pay off the national debt, stop inflation, reduce unemployment, give us a new birth of freedom, restore prosperity to our people, and make America, again, the Land of Opportunity.

■ ■ ■

PAUL C. FISHER (702) 293-3011

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BOULDER CITY, NEVADA 89005

Paul Fisher is President and owner of the Fisher Pen Company with plants in Forest Park, Illinois, and Boulder City, Nevada. He founded the Company in 1948 in order to continue his research and efforts to improve the ball point pen.

He is an engineer and inventor with several successful patents including the pressurized ball point pen which is used by the Astronauts in Outer Space. This patent also covers the popular new erasable ink pens. He has made many other technical contributions to the ball point industry.

He was born in Lebanon, Kansas, on October 10, 1913, the son of a Methodist Minister. He attended Ellsworth, Kansas, public schools and graduated in 1931 from Mankato Kansas High School.

During the depression, he worked his way through college. In 1931 he entered Kansas Wesleyan University, Salina, Kansas, to become an economist but, after two years, switched to General Science. In 1939, he graduated (Phi Kappa Phi) from Kansas State College, Manhattan, Kansas, with a B.S. Degree in General Science.

He has had many jobs: Janitor, bus boy, waiter, shoe salesman, truck driver, accountant, store manager, speech writer, tool designer, consulting engineer, designer and builder of automatic machines. He was General Manager of the Cedar Rapids Bakery, Cedar Rapids, Iowa, 1935 to 1937. He was a senior public accountant with Frazer & Torbet, CPA's, Chicago, Illinois, 1941 and 1942. He was Assistant to the President of Aetna Ball Bearing Mfg. Co. Chicago, 1943 to 1945; General Manager of Fisher-Armour Mfg. Co., 1946 to 1948; and owner-manager of Fisher Pen Company from 1948 to 1982. In 1980, he was Small Business Person of the Year for the State of Nevada.

In 1954, in a widely publicized case, he spent twelve days in jail for Contempt of Court for refusing to open his proprietorship books to the Wage and Hour Division of the U.S. Department of Labor for "an unlawful search without probable cause in violation of the Fourth Amendment." When he was later accused of violating a law, he opened his books, no violations were found and all charges against him were dropped. He stated, "I wanted to show that the Courts do not literally, honestly and accurately uphold the Law."

In 1960, he wrote the book, "Road to Freedom - - An analysis of the Scientific Technique and How It Can Be Applied To Our Threatening Economic Problems of Inflation and Unemployment." In order to bring his ideas to the attention of the American People, he entered the New Hampshire Democratic Presidential Primary on a platform to abolish all taxes on the first $10,000 of income for everyone. He lost that primary to John Kennedy.

In 1968, he rewrote his book and published it under a new title, "TAX REFORM - - America at the Brink."

He is a father with seven children and a grandfather of five.

Mr. STARK. The next witness is Mr. Herbert J. Lerner. Mr. Lerner?

STATEMENT OF HERBERT J. LERNER, PARTNER IN CHARGE OF WASHINGTON TAX SERVICES, ERNST & WHINNEY

Mr. LERNER. Thank you, Mr. Chairman.

Mr. STARK. Welcome to the committee.

Mr. LERNER. My name is Herbert J. Lerner. I am in charge of Washington tax services for Ernst & Whinney. I will summarize our views on the completed contract method of accounting and the new corporate minimum tax proposal.

I would appreciate your inclusion of our complete statement, which also covers the modified coinsurance proposals, in the record of these hearings.

Mr. STARK. Without objection, it will appear in the record in its entirety.

Mr. LERNER. As to the completed contract method, we are opposed to that and its replacement by the percentage of completion method or the progress payments method. We do not believe that either of those methods as conceived and applied from a tax standpoint should be mandated as the only acceptable methods for long-term contracts. Either of those methods may create substantial inequities for certain contractors.

The percentage of completion method is based on estimates of both final contract sales price and the cost to perform. Contract costs to perform can include provisions for warranty, estimated subcontract overruns or underruns, and procurement estimates for which final prices may not have even been negotiated in advance with the vendors.

This process requires a substantial amount of judgment to make the determination of cost as well as the portion of the work that has been completed. The IRS has historically resisted the attempt by taxpayers to use estimates in accounting for income and deductions. Thus, it seems inconsistent to require that taxpayers use the percentage of completion method for tax reporting purposes.

Under the progress payment method the taxpayer would not be required to use estimates, but they would be required to include in income any advance payments on the contracts, loans from the purchaser, or loan proceeds where the contracts are used as a security for the loans.

This is a novel concept of taxing amounts when they are received in cash—a cash flow approach, and we believe it raises serious basic issues, since it may well have the effect of taxing capital. For example, under fixed price incentive contracts with a cost-sharing clause, with an estimated cost underrun at completion, the taxpayer could incur a tax liability on a portion of amounts ultimately to be refunded to the customer.

Alternatively, if the contract terms call for an advance of funds late in a tax year for costs to be incurred, in the early part of the next year, the contractor would incur a tax on hypothetical income. At best it appears to us that the Treasury proposal is only a piecemeal adoption of the percentage of completion method, since it ignores the basic financial reporting concept that applies under

both the percentage of completion and the completed contract methods; that is, recognition of the entire loss on a contract in the year when the loss first becomes evident.

We fail to see how the Treasury's proposals will necessarily result in a clearer reflection of income unless the loss is recognized for tax purposes when it becomes evident that a contract will result in a loss.

The completed contract method recognizes revenue when the earnings process is complete or virtually complete. The method allows the contractor to avoid having to forecast future events, which is often a very difficult problem in the construction industry.

We also believe if there are perceived abuses in the application of the completed contract method, rather than eliminating a method that has been in place for 64 years under our tax system, the IRS should use its current regulatory authority to correct those abuses. Nevertheless, we suggest that any change, if it is to be made, not preclude the use of the completed contract method for long-term contracts prior to a period of 3 years for a given contract or construction project. Such a 3-year exception often would provide a sufficient period of time under a given construction contract to permit a more reliable estimate of the ultimate profitability of the contract.

Finally, if a mandatory change from the completed contract method is included in the legislation, we urge that you provide effective transitional rules. Our detailed statement urges the use of a traditional 10-year spread rule consistent with other changes in tax accounting method and the alternative use of a suspense account approach for dealing with the presently deferred level of income.

As to the corporate minimum tax proposals, we believe that is contrary to the main thrust behind last year's Economic Recovery Tax Act. Companies in capital-intensive industries that have committed themselves to long-range capital investment and which have absolutely no tax preferences may find that their tax liability will be significantly increased.

The proposed new minimum tax detracts from the intended purpose of the investment credit because the credit cannot be used to offset the tax. The effect of this is to defer a substantial portion of the investment tax credit.

Another problem with the alternative minimum tax proposal is that it can impose a tax even though there is no economic gain to the corporation. The impact of this provision on a new company that incurs startup losses or on an established company that has recently incurred losses can be very significant.

Take the case of a company that incurs a significant loss in 1982 which it begins to reverse in part over the next few years. Under our present tax structure that loss would be carried over and used to offset future profits for the next 15 years. However, under the proposed minimum tax the company would be forced to pay taxes in its recovery period despite the fact that the company would still have unrecovered losses. This results in an immediate cash drain at a time when the company can least afford to and indeed should not pay income taxes.

The new minimum tax proposal would also add another layer of complexity to our tax laws. We believe such a drastic change in our

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tax system which will reverse or limit the utility of many tax incentives, many of which were enacted just last year, 8 months ago, should not be made without compelling reasons and only if it permits taxpayers to address to the changes on a prospective basis.

Expected yields in the investment of this type are carefully calculated and appraised before a decision to invest is made. To impose a minimum tax now on the deposit interest deductions allocable to carry such securities that were required years ago seems to us to be grossly unfair.

Our detailed statement addresses a number of related issues involving the alternative minimum tax.

I thank you for your attention to these summary comments.

[The prepared statement follows:]

STATEMENT OF ERNST & WHINNEY
ON THE TREASURY DEPARTMENT'S TAX REVISION PROPOSALS
RELEASED FEBRUARY 26, 1982

We appreciate this opportunity to comment on the Administration's 1982 tax proposals for income tax revision.

Ernst & Whinney is an international firm of Certified Public Accountants with more than 300 offices in 70 countries. We provide accounting, auditing, tax and management consulting services to corporate, individual and other clients engaged in various business and governmental activities. However, none of our comments are made on behalf of specific clients of our firm.

* * *

SUMMARY OF POSITION

Completed Contract Method Proposals

We are opposed to the elimination of the completed contract method and its replacement by either the percentage of completion method or the progress payment method. We do not believe that either of those methods as conceived and applied from a tax standpoint will more clearly reflect taxable income.

The percentage of completion method is based on estimates of both the final contract sales price and the cost to perform. Under the progress payment method, taxpayers would not be required to use estimates, but they would be required to include in income any advance payments on the contracts, loans from the purchaser, or loan proceeds where the contracts are used as security for the loans. This novel concept of taxing amounts when they are received -- a cash flow approach -- raises serious basic issues since it may have the effect of taxing capital.

However, if the completed contract method is to be curtailed for tax purposes, we urge that it be done only on a prospective basis and with appropriate transition rules which include the elective use of a suspense account approach or a traditional 10-year spread of resulting adjustments. In addition, we suggest that any such change not preclude the use of the completed contract method for long-term contracts prior to a period of three years for a given contract or construction project. Such a three-year exception often would provide a sufficient period of time under a given contract to permit a more reliable estimate of the ultimate profitability of the contract.

Corporate Minimum Tax

Effective January 1, 1983, the present add-on corporate minimum tax on certain items of tax preference would be replaced with a new 15 percent alternative minimum tax on "adjusted corporate profits" in excess of $50,000, which must be paid only if it exceeds the regular corporate income tax.

Because adjusted corporate profits do not take into account net operating loss carryovers and because the alternative minimum tax cannot be offset by the investment credit, the alternative minimum tax in many cases would apply to taxpayers with none of the proscribed preference items. Companies with no economic profits for a period of years still

could be required to pay an alternative minimum tax during that period. This does not seem to be either desirable or logical.

In our view, the minimum tax proposals will bring a complexity to our tax laws that is not needed at this time. Such a drastic change in our tax system, which will reverse or limit the utility of many tax incentives -- some of which have been in the tax law for many years and others which were enacted only eight months ago -- should not be made without compelling reasons and only if it contains fair transitional rules that will permit taxpayers and other affected parties to adjust to the changes on a prospective basis.

We believe it would be better for Congress to re-examine the underlying tax relief or incentive provisions, which is traditionally done on a prospective basis, rather than impose an alternative minimum tax that has a retroactive impact.

Modified Coinsurance

The Administration proposals to repeal section 820 dealing with the optional treatment of modified coinsurance contracts and to clarify the treatment of experience refunds should not be considered in isolation from the other aspects of taxation of life insurance companies. Instead, we recommend that temporary measures be developed which are equitable to the industry, provide for an adequate level of tax, and preserve the opportunity for economic balance within the industry. This should be followed by an all-out effort by the Treasury, Congress, and the life insurance industry itself to study the required changes to Subchapter L that will result in fair and equitable taxation of the life insurance industry in today's environment.

COMPLETED CONTRACT METHOD OF ACCOUNTING

Current Law

Presently, a taxpayer may use either the percentage of completion method or the completed contract method for long-term contracts. A taxpayer also may use any other acceptable accounting method for its long-term contracts, such as the accrual method or the accrual shipments method under section 446 of the Internal Revenue Code.

Proposed Changes

Elimination of the Completed Contract Method: Under the legislative proposal, taxpayers would not be allowed to use the completed contract method of accounting for contracts entered into after February 26, 1982.

Required Methods: Under the proposal, taxpayers would be required to use either the percentage of completion method or the progress payment method.

- Percentage of Completion Method - Under this method, taxpayers are required to report income based on the percentage of work completed. Costs may be deducted in the year paid or incurred.

- Progress Payment Method - Under the progress payment method, a taxpayer must include in income all payments when the right to receive such payments accrues. This would include any amounts the taxpayer is entitled to

receive under the contract. A taxpayer would also be required to include in income any amounts received in the form of loans from the customer or loans from third parties where the contract was used to secure the loan. This method would also contain a special rule for advance payments received or accrued before work on a contract has commenced.

Under the progress payment method, income will be reported on a contract by contract basis. Income will be recognized during the course of the contract when payments received or accrued exceed the total current and previously unclaimed costs. Losses will be recognized only if the costs incurred exceed the total amount the taxpayer has the right to receive under the contract.

Under the progress payment method a taxpayer would be required to allocate the majority of its costs to the contract. Such costs would be deducted only when the taxpayer has the right to receive payment under the contract and then only to the extent of such payment. The only exception to this rule is with respect to the following costs which would be treated as period costs:

(a) General marketing, selling and advertising expenses;

(b) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer;

(c) Research and experimental expenses neither directly attributable to particular long-term contracts in existence at the time such expenses are incurred nor incurred under any agreement to perform such research or experimentation;

(d) Losses under section 165 and the regulations thereunder;

(e) Depreciation and amortization on idle equipment and facilities;

(f) Income taxes attributable to income received from long-term contracts;

(g) Pension contributions to the extent that they represent past service costs; and

(h) Costs attributable to strikes.

Ernst & Whinney Comments

Advantages of Completed Contract Method. The completed contract method has an important place in the reporting of income under the Internal Revenue Code and has been an acceptable concept of tax reporting since 1918. In fact, a substantial number of companies also use this method for financial reporting purposes. Although it tends to bunch income in the year of completion, there are enough advantages to justify the continued permissibility of this method.

The completed contract method recognizes revenue when the earning process is complete or virtually complete. The method allows the contractor to avoid having to forecast future events -- often a very difficult problem in the construction industry. Events and circumstances can often create estimated contract fluctuations during the period of performance. Therefore, for sound tax policy reasons, the completed contract method recognizes the inherent risks and uncertainties of contract performance that face the typical contractor.

Many other contractors do, in fact, have a significant profit risk in their contracts that is not resolved until final completion of the contract. Contracts that result in losses may not be identified until the final phase of completion. To prohibit use of the completed contract method for these kinds of contracts is not desirable.

Finally, we believe that if there are perceived abuses in the application of the completed contract method, rather than eliminating a method that has been in place for 64 years, the IRS should use its current regulatory authority to correct those abuses.

Disadvantages of Percentage of Completion Method. Under the Treasury proposal, taxpayers would be required to use the percentage of completion method or the progress payment method for long term contracts. We do not believe that either method as conceived and applied from a tax standpoint will necessarily more clearly reflect a taxpayer's taxable income. The percentage of completion method is based on estimates of both the final contract sales price and the cost to perform. Sales price estimates include, but are not limited to, consideration of items such as:

(1) Contract change orders, priced or unpriced which may or may not have been negotiated with the customer.

(2) The impact of any cost performance incentive fee provisions.

(3) The impact of any technical performance incentive fee provisions.

(4) The impact of any unilateral award fees.

(5) Estimated unallowable costs which are subject to future negotiations with the customer.

Contract costs to perform can include provisions for warranty where appropriate, estimated subcontractor overruns or underruns, and procurement estimates for which final prices may not have been negotiated in advance with the vendors. This process requires a substantial amount of judgment to make the determination as to the portion of the work that has been completed.

The IRS has historically resisted the attempt by taxpayers to use estimates in accounting for income and deductions. Thus, it seems inconsistent to require that taxpayers use the percentage of completion method for tax reporting purposes. Furthermore, under the percentage of completion method taxpayers may be required to report income and pay taxes even though the contract terms and conditions may preclude billing the customer until some time in the future. Moreover, the percentage of completion method as applied for tax purposes does not generally permit current deductibility of anticipated losses on partially completed contracts.

Disadvantages of the Progress Payments Method. Under the progress payment method, taxpayers would not be required to use estimates, but they would be required to include in income any advance payments on the contracts, loans from the purchaser, or loan proceeds where the contracts are used as security for the loans. This concept of taxing amounts when they are received raises serious basic issues, since it may have the effect of taxing capital.

The progress payment method could result in tax payments and tax liability being determined on the basis of the contract billing terms or cash flow rather than on the profitability of the contract. Taxpayers may be in a situation where they have a loss contract, but because they have received advance payments or there are progress billings in excess of costs to date, they would be reporting income on such amounts. For example under a fixed-price incentive contract, with a cost sharing clause and an estimated cost underrun at completion, a taxpayer could

incur a tax liability on a portion of amounts ultimately to be refunded to the customer. Alternatively, if contract terms call for an advance of funds late in a tax year for costs to be incurred in the early part of the subsequent tax year the contractor would incur a tax liability on hypothetical income.

Tax Reporting vs. Financial Accounting. The Treasury proposal implies that the percentage of completion method is the preferred method for tax reporting and for financial accounting purposes. It seems to us that the Treasury proposal is founded on the presumption that financial reporting criteria should be used to govern tax reporting for long-term contracts. However, the objectives of financial reporting and tax reporting are frequently not the same. In fact, the Financial Accounting Standards Board (FASB) states in its Statement of Financial Accounting Concepts No. 1 that

> "Investors, creditors, and others may use reported earnings and information about the elements of financial statements in various ways to assess the prospects for cash flows. They may wish, for example, to evaluate management's performance, estimate "earning power," predict future earnings, assess risk, or to confirm, change, or reject earlier predictions or assessments."

In addition to the FASB, other accounting guidelines have evolved from various regulatory or standard setting bodies. These include the Cost Accounting Standards Board (CASB), Government Accounting Standards Board (GASB), Department of Defense (DOD), General Services Administration (GSA), and Interstate Commerce Commission (ICC). Each of these organizations has issued its own separate accounting and costing rules which may or may not be symmetrical with financial or tax reporting.

On many occasions, the Supreme Court has stated that the objectives of taxation and financial reporting differ and, therefore, the treatment of a particular item does not have to be consistent. A contractor may use

its financial statements for loan financing, a bonding rating, shareholder reporting, etc. However, these purposes are entirely different from the objective of reporting income for tax purposes.

At best it appears that the Treasury proposal is only a piecemeal adoption of the percentage of completion method, since it ignores a basic financial reporting concept that applies under both the percentage of completion and completed contract methods -- recognition of the entire loss on a contract in the year when the loss first becomes evident. The Treasury proposal would recognize income under the percentage of completion method, but would not allow for losses under that method. We fail to see how Treasury's proposals will necessarily result in a clearer reflection of income unless a loss is recognized for tax purposes when it becomes evident that a contract will result in a loss.

Exception for the First Three Years of a Long-Term Contract

If a legislative change is to be made which would curtail or eliminate the use of the completed contract method, we urge that such change not apply to the first three years of a given long-term contract. At the end of the third year, if the taxpayer has not completed the contract, the taxpayer would have to account for that contract under the progress payments method or under the percentage of completion method. If the progress payments method is used at that time, it should apply with due regard for additional costs which are incurred up to the time of filing the tax return for the year which includes the third anniversary of commencement of construction under the contract.

Such a three-year exception would reduce the burdens and problems of either the progress payments method or the percentage of completion method for many long-term construction or manufacturing contracts, especially during the most uncertain early years of the contract.

In addition, the exception would avoid imposing new rules and cash flow problems for many smaller contractors who typically do not have contracts which extend beyond three years.

Allocation of Costs to Contracts

Current Law

Currently a taxpayer must allocate to a contract all direct costs and those indirect costs which are incident to and necessary for the performance of a particular long-term contract. This would include rent, utilities, maintenance, etc. Costs which are not required to be allocated, referred to as period costs, include interest, selling expenses, bidding expenses, research and development, and other similar-costs which benefit the taxpayer's activities as a whole.

Proposed Change

Under the Treasury proposal, taxpayers would be required to allocate to contracts in progress not only those costs presently required to be allocated but some costs that were previously treated as period costs. These costs would be deducted only as the related revenue from a contract is recognized. Thus, a taxpayer would be required to include not only all direct costs and indirect costs incident to and necessary for the performance of a particular long-term contract, but also certain other costs such as excess depreciation, bidding costs on successful contracts, general and administrative costs, research and development costs, interest, and employee benefit costs. Only the following costs would be excluded from this requirement.

(a) General marketing, selling and advertising expenses;

(b) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer;

(c) Research and experimental expenses neither directly attributable to particular long-term contracts in existence at the time such expenses are incurred nor incurred under any agreement to perform such research or experimentation;

(d) Losses under Section 165 and the regulations thereunder;

(e) Depreciation and amortization on idle equipment and facilities;

(f) Income taxes attributable to income received from long-term contracts;

(g) Pension contributions to the extent that they represent past service costs; and

(h) Costs attributable to strikes.

Ernst & Whinney Comments

The current rules regarding the allocation of costs to a contract have evolved over a long period of time. In fact, the current regulations were revised in 1976 after long and careful study. Thus, we believe that any change in the allocation rules should only be made after a thoughtful analysis of the reasons for allocating costs to a contract, the relationship of the costs to a contract, and the general tax policy for allowing a particular cost to be deducted in the first place. For

example, the deduction for research and development was added to the Code to encourage taxpayers to expand their research and development activities. Moreover, just last year Congress encouraged additional research by allowing a new tax credit for incremental research and development expenses. A change to require these costs to be allocated to the contract appears to be contrary to the reasons for enacting that provision.

The proposed changes to the long-established costing rules would also have the effect of putting contractors at a disadvantage compared to other taxpayers. The costing rules for the completed contract method of accounting are based on the tax accounting rules for inventories. The cost must be "incident to and necessary for" the long-term contract in order to be allocated directly to that contract.

Under the inventory rules, the majority of the costs the Treasury now proposes to require to be capitalized are deducted currently as period costs. In fact, in Rev. Rul. 79-25, 1979-1 CB 186, the IRS took the position that these costs should not be allocated to inventory, but should be treated as period costs. Period costs include either those costs that are not clearly related to the production of a particular item, or are incurred without actually benefiting future periods.

The proposal will add complexity to this area because it is unlikely that a number of these costs can be properly attributable to specific contracts. For example, interest expense may reflect the cost of raising working capital. Even if interest arises due to the financing of one contract, it is likely, especially with smaller contractors, that the loan proceeds will be used wherever they are needed in the business. Interest cannot on a realistic basis be attributed to one aspect of a business when in fact the proceeds to which it relates are used in other aspects of that business. Thus, according to the completed contract and inventory accounting rules and objectives, interest should be deducted

currently. In addition, other taxpayers who have the same working capital needs can continue to deduct interest currently.

Proposed Effective Date

The proposals would be effective for taxable years beginning after December 31, 1982. Taxpayers may continue to use the completed contract method of accounting for any contracts entered into on or before February 26, 1982. For those contracts entered into after such date, the taxpayer will be required to use the percentage of completion method or the progress payment method for all costs incurred and profits realized in taxable years beginning after December 31, 1982.

Ernst & Whinney Comments

Generally, the Service has required taxpayers to account for any changes in method of accounting by spreading the adjustment over an appropriate number of years. Under Rev. Proc. 80-51, 1980-2 CB 818, the Section 481 adjustment is usually spread over a period of 10 taxble years. The proposed rule, however, does not even allow for this type of transition.

We believe that taxpayers should be allowed to use either a suspense account approach or the traditional 10-year adjustment period for any Section 481 adjustment since these methods have been used in the past to account for adjustments and changes of methods of accounting. While we do not agree with the proposed change for long-term contracts, we believe the establishment of a suspense account for contracts in progress is the most equitable approach in the event the completed contract method is eliminated.

Suspense Account Adjustment. This approach has been used selectively in other areas to deal with legislative changes in the tax accounting

treatment of certain items, e.g., Section 463 dealing with non-vested vacation pay and Section 166(f) dealing with reserves for certain guaranteed debt obligations.

Under the suspense account approach, taxpayers would be required to establish a suspense account for those amounts that are currently deferred under the completed contract method. The amount in the suspense account would be included in income as a taxpayer's deferred profit falls below the level in the suspense account. See Exhibit A for an illustration of how the suspense account approach would work.

Section 481(a) Adjustment. An alternative to the suspense account approach would be to provide for a Section 481(a) adjustment for any contracts in progress at the beginning of the year of change.

For example if the taxpayer changed to the percentage of completion method the adjustment would be computed based on the amount of work previously performed on contracts in progress at the beginning of the year of change and would be spread over 10 years. The Section 481(a) adjustment approach provides a vehicle to prevent amounts from being duplicated or omitted. At the same time, it helps to ameliorate any distortion of income that would occur in the year of change.

EXHIBIT A

Illustration of Suspense Account Approach

Operation of Method: To prevent a doubling up of income in the first year that the completed contract method is eliminated, taxpayers would establish two accounts. The first account (the contracts in progress account) would be based on the amount of work performed on those contracts at the beginning of the year of change. For example, if a calendar year taxpayer had contracts in progress which ultimately would result in profits of $500,000 on January 1, 1983, and the contracts were all 50% complete, the opening balance in the account would be $250,000. Taxpayers would also establish a second account (the suspense account) in the same amount.

To prevent the permanent deferral of the amount in the suspense account, taxpayers would be required to include in income any reduction in the contracts in progress account at the end of any given year; that is, the suspense account is reduced in the amount by which the beginning balance of the suspense account exceeds the ending balance in the contracts in progress account. For example, assume the suspense account has an opening balance of $250,000 on January 1, 1983 and at the end of the year the taxpayer had only $200,000 in its contracts in progress account. Since the end of year balance of the contracts in progress account is less than the beginning balance in the suspense account (by $50,000), the taxpayer would include the $50,000 in income and would reduce the suspense account by $50,000. (This procedure might apply in future years to require restoration to income of the balance in the suspense account, pro tanto, as the taxpayer reduces its level of contracts in progress in those years.)

The following example illustrates in greater detail the use of the suspense account approach.

Example: Corporation Y, a calendar-year taxpayer, reported income on the completed contract method with the contracts being completed in the year following the year they are started. Assuming Y changes to the percentage of completion method for 1983, the comparative results are as follows:

(1)	(2)	(3)	(4)	(5)
At the Close of —	Income Earned on the Percentage of Completion Method**	Suspense Account Balance Beginning of Year	Income or (Deduction) under Suspense Account	Total Income (2) + (5)
1982	125,000	-	-	-
1983	140,000	$125,000	-	$140,000
1984	110,000	125,000	$ 15,000	125,000
1985	130,000	110,000	(15,000)	115,000
1986	-0-*	125,000	125,000	125,000

* For illustrative purposes only.
** This column is the cumulative amount in the contracts in progress account.

In this case, the initial suspense account balance equals $125,000. At the close of 1984 there is a decrease of $15,000 in the suspense account balance. The taxpayer would be required to include this amount in income. For 1985 the beginning of the year suspense account balance ($110,000) is less than the end of the year contracts in progress account ($130,000) by $20,000. Only $15,000 of this amount is deducted and the suspense account balance is only increased to $125,000. For 1986 the beginning suspense account balance ($125,000) exceeds the closing contracts in progress account (-0-) by $125,000. This amount is includible in income in 1986.

NEW CORPORATE MINIMUM TAX

Current Law

Under present law, corporations must pay an add-on minimum tax equal to 15 percent of certain items of tax preference in excess of the greater of either $10,000 or 100 percent of the corporation's regular income tax liability. These items of tax preference are:

(1) 18/46 of net long-term capital gains;

(2) percentage depletion in excess of the adjusted basis of the property;

(3) depreciation in excess of straight line on low-income rental housing, non-recovery property, or 15-year real property;

(4) amortization of pollution control facilities in excess of regular depreciation;

(5) amortization of child care facilities in excess of regular depreciation; and

(6) reserves for losses on bad debts of financial institutions in excess of the reserves that would have been allowed on the basis of actual experience.

Proposed Changes

Effective January 1, 1983, the present add-on corporate minimum tax on certain items of tax preference would be replaced with a new 15 percent alternative minimum tax on "adjusted corporate profits" in excess of $50,000, which must be paid only if it exceeds the regular corporate income tax. No credits other than the foreign tax credit would be allowed to offset the new minimum tax. The excess of the minimum tax paid in any year over the regular corporate income tax liability calculated for that year can be carried over as a credit against the regular tax.

Adjusted corporate profits will be calculated by adding back to a corporation's taxable income (excluding NOL carryovers or carrybacks) the following expanded list of tax preference items.

(1) excess percentage depletion;

(2) accelerated depreciation on real property;

(3) amortization of certified pollution control facilities;

(4) amortization of child care facilities;

(5) reserves for losses on bad debts of financial institutions;

(6) intangible drilling costs;

(7) mining exploration and development costs;

(8) lessors' leasing benefits;

(9) deductions for debt to buy or carry tax-exempt securities;

(10) deferred DISC income;

(11) certain shipping income;

(12) amortization of motor carrier operating rights;

(13) excess interest on original discount bonds; and

(14) deductions for certain costs incurred with respect to long-term contracts.

Ernst & Whinney Comments

The proposed new minimum tax on corporations seems contrary to the main thrust behind last years Economic Recovery Tax Act -- to encourage increased capital investment by business. Companies in capital intensive industries that have committed themselves to long-range capital investment and which have absolutely no "tax preferences" may find that their tax liability will be significantly increased under the Administration's proposal. The proposed new minimum tax effectively reduces the limitation on the investment tax credit from 90% of tax liability, enacted by Congress in 1978, to approximately 67%. This occurs because the investment tax credit cannot be used to offset the minimum tax under this proposal. The effect of this is to defer the use of a substantial portion of the investment tax credit.

Another problem with the alternative minimum tax proposal is that it can impose a tax even though there is no economic gain to the corporation. The impact of this provision on a new company that incurs start-up losses or upon an established company that has recently incurred losses can be very significant. The following example illustrates the point:

Example: Assume that a company has incurred a $100 million loss for 1982 that can be carried over and offset against profits for the next 15 years under current law. Assume

further that beginning in 1984 the company shows small but increasing profits for the next few years.

Economic Income
Effect of Net Operation Loss

	1983	1984	1985	1986
Regular Tax				
Taxable Income	-0-	$10,000,000	$15,000,000	$20,000,000
1982 NOL Carryover ($100,000,000)		(10,000,000)	(15,000,000)	(20,000,000)
Regular Taxable Income	-0-	-0-	-0-	-0-
Regular Tax at 46%	-0-	-0-	-0-	-0-
Minimum tax				
Taxable Income	-0-	$10,000,000	$15,000,000	$20,000,000
Minimum Tax at 15%	-0-	$ 1,500,000	$ 2,250,000	$ 3,000,000
Tax Due		$ 1,500,000	$ 2,250,000	$ 3,000,000
Minimum Tax Credit Carryover		$ 1,500,000	$ 3,750,000	$ 6,750,000

The example shows that under our present corporate income tax structure, the company would pay no taxes for 1982-1986 due to the large 1982 loss carryover. However, under the proposed minimum tax the company would pay approximately $6,750,000 in taxes over the same period despite the fact that the company would still have unrecovered losses. And, even though a portion of the minimum tax paid may eventually be recovered as a credit against regular taxes, there is an immediate cash drain at a time when the company can least afford to -- indeed should not -- pay income tax.

In our view the minimum tax proposal will bring a complexity to the tax law which is not needed at this time. Because of the special structure needed to impose a minimum tax of the type being proposed it is particu-

larly burdensome to apply. The minimum tax produces significant complications, makes tax and financial planning more difficult, and as a result is directly contrary to desirable tax simplification efforts.

The Treasury in its explanation of the new corporate minimum tax states that:

> "The existing "add-on" minimum tax applies to corporations that have reduced their tax liability through the use of designated tax deductions, but is not focused upon corporations that pay little or no regular income tax. The proposed corporate minimum tax would tax "corporate profits," as measured by regular taxable income plus certain special deductions . . . ."

This statement would lead us to believe that there is a conceptual difference between the old add-on minimum tax and the new tax being proposed. We do not see it that way. The new tax although structured differently is nothing more than a tax on an expanded list of tax preference items. We view the proposed tax as a penalty on those businesses employing tax relief or incentive provisions that by themselves were considered appropriate and consistent with national goals by Congress and previous Administrations. This is not to imply that all these provisions should be treated as sacrosanct forever.

We believe that a better approach would involve the careful reconsideration of previously enacted tax relief/incentive provisions. If Congress finds in view of changing economic conditions that these provisions are now too generous, not needed, or perhaps not generous enough then they should be revised accordingly. Of course, this will take time but we believe it is a far better approach and one that will restore investor confidence rather than undermine it.

Imposition of a new minimum tax will further undermine our economic recovery since long-term investment decisions require a high degree of

certainty before investors will be willing to commit their funds. But perhaps even more important is the fact that the proposed minimum tax may affect business planning and decisions that in some cases were made long ago. For instance, decisions by banks to invest in tax-exempt securities are usually the product of long range planning. Expected yields from investments of this type are carefully calculated and appraised before a decision to invest is made. To impose a minimum tax now on deposit interest expense incurred to carry investments in tax-exempt securities that were acquired years ago seems to us to be most unfair. Similarly, the decision to invest in drilling, mining exploration or planning with respect to exports and foreign operations is also the product of long range planning, and to impose a tax on these kinds of investments after they have been made is unfair.

The new proposed minimum tax will affect many industries adversely. In some cases these are the industries most in need of assistance. The following items which would be included as tax preferences in the new alternative minimum tax base suggest the need for consideration of special transitional or exception provisions:

(1) Intangible drilling costs - This item would include the deduction for intangible drilling and development costs of oil, gas and geothermal wells (other than dry holes) in excess of the amount allowable had the costs been capitalized and amortized on the straight line basis over 10 years. There would be no offset for the net income from the properties for the year, as there is under the minimum tax for individuals.

Effect: This item would directly impact the petroleum and natural gas drilling industry. Much of our country's energy resource development is accomplished by smaller independent drillers and refiners and these companies could be significantly impacted by the new provision. If this tax is imposed

it may result in reduced drilling and exploration for new sources of energy.

(2) Mining exploration and development costs - This item would include deductions for mining exploration and development costs in excess of the amortization that would have been allowable on the straight line basis over 10 years.

Effect: One of the important national energy goals during the past decade was to reduce our dependence on imported oil through the use of substitute fuels, such as coal. During this period various incentives were enacted to encourage the production and use of coal and to a large degree these incentives have met with success. The inclusion of mining exploration and development expenses as a tax preference will have just the opposite effect. In addition, it will penalize firms that have already invested funds in this area and made plans based on well-established national objectives.

(3) Deductions for debt to carry tax-exempt securities - This item would include interest on indebtedness to purchase or carry tax-exempt securities, to the extent this interest is deducted under current law. In determining the amount of the interest deduction to be added to the minimum tax base, the corporation's total interest deductions will be allocated pro rata across its total investment portfolio.

Effect: This provision would have its greatest impact on the banking industry, since the normal rule under Code Section 265 disallowing the deduction of expenses and interest relating to tax exempt income does not apply to commercial banks (or certain other financial institutions that have less than 15% of their total assets invested in tax-exempt securities). Some banks have already estimated there will be sharp increases in

their taxes if the new alternative minimum tax plan is approved. The Treasury's own estimates indicate that the tax on the banking industry as a whole would be increased by approximately 50% from its current level.

In addition, this provision is directly contrary to a long-established policy of providing assistance to state and local governments and other tax exempt entities with their financing. The provision will force states and localities to offer higher interest rates in order to compete with others for funds and will further depress an already depressed tax-exempt bond market.

(4) Deferred DISC income - This item would include a corporate shareholder's pro rata share of DISC income for the year that is not taxed currently.

Effect: The DISC provisions were originally enacted to encourage exports and to enable us to compete more effectively in the European common market. The provisions will have an adverse effect on these objectives and are contrary to arguments advanced by the U.S. Treasury in the latest trade and tariff negotiations with European common market countries.

(5) Amortization of motor carrier operating rights - This item would include all deductions claimed under the five-year amortization provisions added by the Economic Recovery Tax Act of 1981 for motor carrier operating authorities which diminished in value as a result of the deregulation of motor carriers on July 1, 1980.

Effect: The Motor Carriers Act of 1980 deregulating the motor carrier industry virtually eliminated the value of operating rights owned by the carriers. Consequently, many carriers

which had made substantial investments in operating rights were suddenly faced with a nearly total loss on their investments. Congress recognized this hardship in the legislative history of the Motor Carrier Act and stated that deregulation might require further consideration of relief for the diminution in value of these rights. These conclusions were reaffirmed when such relief was provided as part of ERTA. We are not aware of any change in perceived need for such relief.

(6) Excess OID interest - This item would include interest deductible on original issue discount (OID) bonds in excess of the amount that would be deductible were the original issue discount amortized according to a method which yields the same pattern of deductions that would result from borrowing the same amount of money with par-value bonds having the same yield to maturity.

Effect: The presently outstanding debt issues which would be affected by this provision were priced and offerred at a time when the tax rules did not include a taint on the excess OID interest. Retroactive application of this rule is not appropriate.

MODIFIED COINSURANCE

Current Law

The Life Insurance Company Income Tax Act of 1959 was enacted to provide Treasury with an appropriate level of tax revenue from the life insurance industry. Thus, it was anticipated that the industry would be paying its "fair share" of the total corporate income tax--essentially a legislative judgment. At the same time, the Act was designed so that the total tax burden would be apportioned in an equitable manner between the two major segments of the industry -- the mutual companies and the stock companies -- while also providing features to benefit small and new life insurance companies.

Substantial changes in the economy, as well as in the life insurance industry, have occurred since 1959. The high rate of inflation in recent years together with concomitant high interest rates have had the effect of increasing the effective tax rates of many life insurance companies. Under the 1959 tax formula, the incremental tax rates on additional investment income easily can exceed the 46 percent statutory rate and theoretically can exceed 100 percent. According to one industry report, the share of total corporate tax paid by the life insurance industry rose from about 2-1/2 percent of total corporate tax in 1960 to about four percent of total corporate tax in 1975. During this same period pension business has become increasingly important to the life insurance industry and new products that did not exist in 1959 have been introduced. These include individual retirement accounts, universal life products, indeterminate premium products, variable life insurance, and single premium deferred annuities. The tax treatment accorded these products is uncertain and may be inequitable.

For these reasons, there is a question as to whether the life insurance industry is paying more or less than its fair share of the corporate income tax. Also, it is difficult to determine whether there is a reasonable apportionment of the tax burden between the mutual and stock companies, so that neither group is able to obtain a competitive advantage solely because of the impact of the federal income tax. Similarly, it is unclear whether the tax is fair insofar as small and new life insurance companies are concerned. The income taxation system should be as neutral as possible as far as competition within the industry is concerned.

Equitable taxation of the life insurance industry involves, as it did in 1959, some very complex issues. There is the long-term nature of many of the products which makes it difficult to determine a proper tax base on an annual basis. The makeup of the industry itself, mutual and stock companies, large and small companies, old and new companies, and companies specializing in certain products makes equitable taxation difficult. In addition, life insurance companies have to compete with other financial institutions for savings' dollars. The resolution of these complex issues requires detailed study which will involve a considerable amount of time.

Proposed Changes

The Administration proposes that Section 820 be repealed. Section 820 provides special rules to govern the tax treatment of modified coinsurance contracts if both parties consent to the specified treatment.

In addition, the Administration proposes to amend Sections 804 and 809 to clarify the treatment of experience refunds.

Ernst & Whinney Comments

The Administration proposals to repeal Section 820 dealing with the optional treatment of modified coinsurance contracts and to clarify the treatment of experience refunds should not be considered in isolation from the other aspects of taxation of life insurance companies. These proposals, in isolation, do not consider whether the industry will be paying its fair share of the corporate income tax and whether there will be tax neutrality among the various segments of the life insurance industry and with other financial institutions.

We also believe that prevention of a double tax is still a valid purpose of Section 820. As stated in the Committee Reports on the 1959 Act, "it is possible for the same income to be taxed twice - once to the initial insurer as investment income and a second time to the reinsurer as underwriting gain." An illustration of this double taxation is attached as Exhibit B.

Because of all of these factors, we do not believe that the Administration proposals with respect to taxation of life insurance companies should be adopted. Rather, temporary measures should be developed which are equitable to the industry, provide for an adequate level of tax from the industry, and preserve the opportunity for economic balance within the industry. This should be followed by an all-out effort by Treasury, the Congress, and the life insurance industry itself to study the required changes to Subchapter L that will result in fair and equitable taxation of the life insurance industry in today's environment.

EXHIBIT B

Modified Coinsurance Example

Before reinsurance, assume the following facts with respect to a block of life insurance business owned by a mutual life insurance company. Assume that the mutual company's tax base includes only investment income (a Phase I company) and the tax rate is 50%.

Premiums received from policyholders	$1,000,000
Investment income earned	80,000
Reserves established	(750,000)
Claims and expenses paid	(250,000)
Profit before income tax	$ 80,000
Income tax	(40,000)
After-tax profit	$ 40,000

Assume that the mutual company reinsures this business on a modified coinsurance basis with a stock company whose tax base includes both investment income and underwriting income (Phase II negative company). The results, without Section 820, are as follows:

	Ceding Company	Assuming Company
Premiums received from policyholders	$1,000,000	$ -0-
Reinsurance premium	(1,000,000)	1,000,000
Return of reserves under modified coinsurance contract	750,000	(750,000)
Payment of investment income related to reserves	(60,000)	60,000
Tax reimbursement	30,000	(30,000)
Net premium income	$ 720,000	$ 280,000
Investment income earned	60,000	20,000
Claims and expenses paid	(250,000)	
Reimbursement of claims and expenses paid	250,000	(250,000)
Reserves established	(750,000)	
Profit before income tax	$ 30,000	$ 50,000
Income tax	(30,000)	(25,000)
After-tax profit	$ -0-	$ 25,000

The result is that the $60,000 of investment income earned by the mutual company with respect to the $750,000 in reserves returned is taxed as investment income to the ceding company and again is taxed as premium income to the assuming company. The total tax for the two companies is $55,000 with reinsurance and only $40,000 without reinsurance.

If an election under Section 820 is made, the results are as follows:

	Ceding Company	Assuming Company
Premium received from policyholder	$1,000,000	$ -0-
Reinsurance premium	(1,000,000)	1,000,000
Net premium income	$ -0-	$1,000,000
Investment income earned	$ 60,000	$ 20,000
Payment of investment income to assuming company	(60,000)	60,000
Net investment income	$ -0-	$ 80,000
Reserves established	$ (750,000)	$ -0-
Reserves transferred	750,000	$ (750,000)
Net reserves established	$ -0-	$ (750,000)
Claims and expenses paid	$ (250,000)	$ -0-
Reimbursement of claims and expenses paid	250,000	(250,000)
Net claims and expenses paid	$ -0-	$ (250,000)
Profit before income tax	$ -0-	$ 80,000
Income tax	-0-	40,000
After-tax profit	$ -0-	$ 40,000

NOTE: No tax reimbursement is required because the assuming company will include the income in its own return.

An election under Section 820 will eliminate the additional tax and leave the assuming company in exactly the same position it would have been in had it written the business itself. This is the same result that would have occurred if the companies had entered into a coinsurance contract rather than a modified coinsurance contract.

Mr. STARK. Mr. Conable.

Mr. CONABLE. Mr. Lerner, Mr. Bafalis apologizes for not being able to be here. I do not wish to take the time of the rest of the panel and of the chairman and myself at this point. We will elicit detailed answers because they are quite detailed questions.

I wonder if I could submit them to you and ask you to respond for the record so that we would have your answers. They relate to the completed contract method generally, and I will give you the written questions so that you will not have to write them down.

There are four of them, and they relate generally to inconsistencies which you have already touched on relating to such issues as, oh, the measurability uncertainty issue, whether the method that the administration is proposing is inconsistent with the tax laws, or the question of disallowance of accelerated depreciation, thus contravening the intent of last year's legislation.

There is some serious inconsistency in the administration's proposal on that, and I would appreciate it if you would respond in writing.

Mr. LERNER. I would be delighted to, Mr. Conable.

[The questions and answers follow:]

ERNST & WHINNEY RESPONSES TO THE COMPLETED CONTRACT METHOD WRITTEN QUESTIONS POSED BY REPRESENTATIVE BAFALIS ON APRIL 1, 1982

Question 1. It is my understanding that the Treasury's position with relation to proposed long-term contract tax regulations would require a taxpayer to capitalize such costs as officer's salaries and other general administrative expenses as well as bidding costs, interest costs, etc.

If this is true, I would appreciate your opinion on the relationship of these expenses to specific long-term contract performance objectives as opposed to benefiting the operation of the taxpayer as a whole.

Response. The current regulations require taxpayers to allocate to a long-term contract any costs that are "incident to and necessary for" the performance of that particular contract. These costs can include general and administrative expenses. However, certain costs are not required to be allocated to a contract if they are incurred in relation to the taxpayer's activities as a whole rather than to a particular contract.

The Treasury proposal would require allocation of some of these costs such as officers' salaries and general and administrative expenses that benefit the operations of the taxpayer's activities as a whole to particular contracts. We believe Treasury's proposal would not only break long-established concepts of treating these costs as period costs, but also would create unnecessary complexity.

For example, while the activities of the chief financial officer of a company may incidentially benefit a particular contract, it is extremely burdensome to segregate or even allocate, with any reasonable accuracy, the portion of that officer's time that is related to a particular contract. Thus, we would question the Treasury proposal both from a theoretical and a practical standpoint.

Nevertheless, if in fact, a cost is clearly applicable to a particular contract we would not object to a requirement for allocating that cost to the contract. For example, a taxpayer might incur legal fees in drafting a long-term contract. Since the amounts are specifically incurred in connection with that particular contract, such amounts could be allocated to the contract. However, in those cases where the costs do not benefit a particular contract, but merely benefit the operations of the taxpayer as a whole, we do not believe that the costs should be allocated to a particular long-term contract. Also, as we indicated in our testimony, if such costs were required to be allocated to a particular long-term contract, they would put taxpayers with long-term contracts at a distinct disadvantage compared to other taxpayers who are allowed to use the traditional inventory method of accounting for cost which does not require such an allocation of general and administrative expenses.

Question 2. I understand the regulatory proposal would disallow a current year deduction for the accelerated depreciation that Congress enacted last year. Wouldn't that contravene the purpose of that legislation?

Response. Yes. The Congress in passing the Economic Recovery Tax Act of 1981 sought to encourage capital formation by providing companies with an accelerated cost recovery system (ACRS). The former depreciation rules were extensively revised in the hope that more liberal deductions for capital cost recovery would encourage taxpayers to invest in capital equipment. Any change requiring the total of ACRS amounts to be capitalized would certainly be contrary to the intent of that legislation. The effect would be to deny taxpayers a current deduction for accelerated depreciation. This is not only contrary to the purposes of ERTA, but also is contrary to the full-absorption rules for inventories. Again, taxpayers with long-term contracts would be at a distinct disadvantage as compared to other taxpayers.

Question 3. The new "Progress Payment Method" could require the payment of taxes on cash received regardless of the ultimate profit or loss on a contract. What are your views regarding such a policy?

Response. The proposed "Progress Payment Method" represents a shift to a concept of taxing cash flow, rather than profits on a contract. This is not a unique concept, in that advance payments are taxed when received unless deferred under applicable Treasury regulations. However, in the case of advance payments for goods, taxpayers are generally allowed a cost offset for those amounts estimated to complete the goods in progress. Under the "Progress Payment Method" taxpayers would be paying taxes on the cash received even though they may incur expenses in the following year that would completely offset the cash received. Thus, as indicated in our testimony, if a taxpayer is required to use the "Progress Payment Method" they should be allowed a cost offset. We have also recommended that taxpayers be allowed to use the completed contract method initially and only be required to switch to the percentage of completion or progress payment method after the third year of the contract.

Question 4. Federal income tax law typically adopts the principles that revenue is not taxable as well as expenses are not deductible until they meet the test of absolute measurability and certainty.

Since the percentage of completion method is based on estimates of both the revenue and cost, is this method inconsistent with tax laws?

Response. The current long-term contract regulations allow taxpayers to use the percentage of completion method. Therefore, it is difficult to say that this method is inconsistent with tax laws. However, the percentage of completion method requires a substantial amount of judgment to make a determination as to the portion of the work that has been completed. The computation of income under the percentage of completion method uses estimates of both the revenue and the costs involved in such contracts. The IRS has traditionally resisted the attempt by taxpayers to use estimates. Thus, in that sense it is inconsistent to require that taxpayers use the percentage of completion method for tax reporting purposes, since that method could be said to conflict with the general tax principles of not permitting the use of estimates.

Mr. CONABLE. Mr. Fisher, I think we share many of your comments here. Your comments are interesting because they are out of the ordinary. We get a great deal of ordinary testimony.

We have generally opposed tax on assets as a tax on capital, a capital levy. The only tax we have which constitutes a capital levy generally is the inheritance tax, and in effect, a tax on assets is a capital levy.

There always have been people offended that we did not tax people because of their status rather than their income. But it is part of the American tradition generally to have some relationship to ability to pay the tax.

Now, clearly a tax on assets would be related to ability to pay, but you run into serious evaluation problems with respect to many types of assets. Thus the major burden of a tax on assets frequently, after Congress is through politicizing it and excluding things like household equipment and cars and so forth, is on capital as such. And many of our friends in other countries in the world have found a capital levy to be the easiest way to stay with socialism. Thus, there is considerable resistance in a traditional American Congress to capital levies as such except in those unique circum-

stances that surround transfer of goods from one generation to another.

I say that only because I see that as a traditional suggestion to an untraditional suggestion you have made to us here today.

I would solicit your comment or not as you see fit.

Mr. FISHER. May I comment?

Mr. CONABLE. Yes, of course.

Mr. FISHER. The income tax, of course, was part of the Communist concept from the beginning. It is a tax on incentive. It is a tax that is designed to destroy free enterprise.

Now, I realize that you are absolutely right that the evaluation of assets is a problem. Since all facts come from experience and we have no experience with this kind of tax, I would recommend that we go into it gradually. But it is obvious today that the income tax and the sales taxes, such as the excise tax are not going to balance the budget. There is no way.

That budget must be balanced eventually. Otherwise you create a society where the rewards go to the speculators, not to the producers, and that is what we have done.

Mr. CONABLE. I understand what you are saying, sir. Many of us doubt that the budget is ever going to be balanced by tax increases. However, there must be other elements in a sound fiscal policy besides tax increases, because the proclivity of public bodies to spend the public money is well known. Unless we can get some restraint on spending, it is generally viewed that we will find ways of spending more than we are willing to tax. That is again a traditional viewpoint from a conservative.

Mr. FISHER. I consider myself very conservative. The biggest problem that civilization has is to control government. As long as government goes untaxed it will grow like a cancer in our society until it destroys human freedom, and destroys the civilization and the people that live under it. That has been the history down through the ages. We must have a handle on government, and the only way is to tax the assets of government as we do the assets of individuals.

Mr. CONABLE. All right. I understand what you are saying. It is difficult to bridge the gap between concept and tradition here, because we generally believe that the Government is sovereign and therefore not subject to taxation. That has been so throughout history. And I do not know for what benefit you would tax Government assets. What you do is you restrain their use generally and their proliferation. The way you do that is not normally by imposing an additional tax on assets.

Mr. FISHER. What I am recommending is——

Mr. STARK. The time of the gentleman has expired.

Mr. Bailey.

Mr. BAILEY. I will be very brief. I would like to propose a certain concept of moderation in all things, not to quibble. Government, of course, can be an enemy. Government is also a protector and it is also a vehicle, an expression of common will, especially in complex societies that effectuate the protection and extension of individual freedoms in certain ways.

I would also ask just one question. Is there a relationship between income and the demand on Government services? Have you ever addressed that question before?

Mr. FISHER. Is there a relationship between income and Government service?

Mr. BAILEY. Is there a relationship between individual income and services demanded and delivered?

Mr. FISHER. Of course there is a relationship, but there is a much higher relationship between assets owned and protected by the Government and Government service.

Mr. BAILEY. Thank you, Mr. Chairman.

Mr. STARK. Mr. Vander Jagt?

Mr. VANDER JAGT. No questions.

Mr. STARK. I want to thank the panel.

Mr. Woodbury, I just had one observation. I appreciate your testimony. Yours is an industry which I am sometimes associated with. I have a concern about not only the industrial development bonds but the mortgage bonds which the real estate industry would like us to support.

What I am finding is that they may not do us any good. We may be subsidizing to a large extent an instrument which is not going to help us as borrowers. If the city of Philadelphia is above 14 percent now and the industry wants a bigger arbitrage or bigger spread for management, if you are in at 15½, you are not very far away from what we might see commercial rates get to be, the spread. The question is going to be: Do we get anybody today to invest long?

The pressure on the short-term market is so intense, both from the Federal Government and from corporate refinance and from the real estate industry, that I am not sure that we are not just going to wreck the municipal market if we add to it. It is not a solution. It may help a few individual projects. But I look and say can I build out a center today with a 16 percent constant at today's interest rates and can a retailer afford that. I am not sure they really can.

I think the problems are so much more basic that if long-term money just existed so we had some long-term stability, it might be better for your industry. Free advice is worth what you pay for it, but I tend to think that is to the construction deduction. I would also submit as somebody who never understood that when it came into being and suffers under it, I would trade off just seeing the construction rates cut in half and capitalize it. I would go out the same door I came in on that one.

I agree with you on that one, but I do not know that we are going to get at it in the mood of picking up revenue at this particular time.

Mr. WOODBURY. If I might comment, Mr. Chairman.

Mr. STARK. Please.

Mr. WOODBURY. You actually referred to, perhaps, three different issues related to the use of the industrial development bond that might be worth comment.

You alluded to the fact that IDB's might be flooding the municipal market. There has undoubtedly been an increase in the number of those bond issues in recent years because it was the only game in town. On the other hand, Mr. Ture's study in 1980—

and I appreciate there has been some change since then—specifically determined that there was only thirty-six one-hundredths of 1 percent of the public bond market that was represented by the IDB's. That is in his study and, although I suspect it is higher than that now, we submit that it really is not having a diluting effect on the prices as far as other municipal bonds are concerned. That is one response.

Second, I think you are quite right about 16 percent. I cannot get retailers to pay enough rent to make a project make sense at 16 percent. Some of us have been a little more innovative, and we are going to a floating rate even on bonds.

One of the things I did not mention and should have in criticizing the President's proposal is his suggestion that IBD's be in registered form to provide certain information. We have suggested that the reporting provisions would provide that same information without having to go to registered form.

Mr. STARK. What is your objection to the registered form?

Mr. WOODBURY. Well, if you are going to go to the public and sell widely, they are going to get shares, you are going to go to a wide market. I have no objection to the registered form in those cases, but many of the bonds are sold to a single investor. It in effect is just a mortgage and in those cases the expense of going through a registration procedure on a single placement would be prohibitive.

Mr. STARK. If you would yield at that point, the registration is not registration in the sense of a SEC registration. This is perhaps an unfounded accusation, but I am not sure anybody has ever denied it. The only reason for having a bearer municipal bond is pretty much to avoid taxation. To avoid taxation, the underground economy picks them up. There are a number of criminal cases we have had, people using unregistered or bearer bonds. All Government bonds, U.S. Treasury bonds, bills have to be book registered or registered now.

If you record a mortgage and an institutional investor buys it, it is an IDB. We will know where he is.

Mr. WOODBURY. That is not what was intended.

Mr. STARK. No

Mr. WOODBURY. The other thing you mentioned was, of course, the long-term commitment, and whether it is going to be revived. I do not know. Certainly, the shorter the commitment, or the more rapid the call provision or whatever in the bond, then the lower the interest rate. In some cases the only way to finance the project we are talking about might be at 16, although it might be possible to get it down to 13 by shortening the term. That is part of the risk some of us are having to take to create these projects.

Mr. STARK. Thank you very much. I want to thank the panel.

The committee will recess until 9 a.m. tomorrow morning.

[Whereupon, at 1:29 p.m., the committee adjourned, to reconvened at 9 a.m., Friday, April 2, 1982.]

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

THURSDAY, APRIL 2, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 9:10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. J. J. Pickle presiding.

Mr. PICKLE. The committee will come to order.

We have three panels today. We look forward to the testimony of the witnesses. The first witness this morning will be the Governor of the State of Missouri. We are proud to have him here.

The Chair is going to recognize our colleague, Congressman Gephardt, to further recognize our guest.

Governor, if you will come forward to the witness table to take your seat, we will proceed.

Mr. GEPHARDT. Thank you, Mr. Chairman.

On behalf of the members of the committee, it is my honor to present and welcome our Governor from Missouri, Christopher Bond.

Governor Bond has been very active in the National Governors Association and is the chairman of a committee there which has been concerned with the furtherance and the carrying on of industrial development bonds.

I think his testimony today will be very helpful to the committee in understanding the importance of the use of these bonds in Missouri and every other State around the country.

I am particularly happy to have my Governor here. I welcome him to the Ways and Means Committee.

Mr. PICKLE. Governor, we are pleased to have you. You come well recommended, in the first place. You are further well recommended when Congressman Gephardt gives official greetings to you. We are very proud to be working with him.

You may proceed to present your testimony in its entirety or to summarize it. Your entire statement will be made part of the record.

STATEMENT OF HON. CHRISTOPHER S. BOND, GOVERNOR OF THE STATE OF MISSOURI AND CHAIRMAN, COMMITTEE ON COMMUNITY AND ECONOMIC DEVELOPMENT, NATIONAL GOVERNORS' ASSOCIATION

Governor BOND. Thank you, Mr. Chairman.

Thank you, Mr. Gephardt, for that warm introduction.

Mr. Chairman, if it is acceptable to you I will give portions of the testimony and submit the rest of the testimony for the record.

I would like to emphasize some aspects of the testimony and beg leave to present it in partial text.

Chairman ROSTENKOWSKI [presiding]. I have read your statement. Your entire statement will be made part of the official record. You may proceed.

Governor BOND. Thank you very much, sir.

It is a pleasure for me to appear on behalf of the National Governors Association to talk about tax-exempt financing. I appear here today, as Mr. Gephardt has indicated, as chairman of the National Governors Association Committee on Community and Economic Development.

I would say it suffices to recognize the fact that all of us know that the country is in a serious recession. Certainly, this is a matter which has come before the attention of this committee, and I need not dwell on the facts or figures which indicate the economic problems we face.

I do want to start out by saying we believe it is extremely important that the Federal, State, and local governments work in a partnership to bring our country back on the road to economic recovery. Congress and the administration called on the States to take on added responsibilities for community and economic development functions. I want to assure you, Mr. Chairman, the members of the committee, and the Members of Congress that the States are willing. But we need the tools to do the job. We must have the flexibility to use them appropriately. States need economic development tools to stimulate job creation, to encourage business expansion, and increase productivity. Virtually all Federal economic development programs have been reduced or in many cases eliminated. Industrial revenue bonds are about the only tool which remains for financing business development in economically underdeveloped or distressed communities. In the present time of austerity when unemployment is a major concern, revenue bonds are a cheaper Federal economic development program than direct Federal expenditure programs that are being cut back. They are available to a large number of jurisdictions and they provide great local flexibility for matching funds with local economic needs. Furthermore, they rely on the private marketplace for the lion's share of funding.

As you probably know, 47 States issue industrial revenue bonds. The principal beneficiaries of small issue industrial development revenue bonds, according to both the Congressional Budget Office and the Department of Treasury, are small businesses. In fact, the primary value of IDRB's is their effectiveness in increasing investment in small businesses. They provide such a large percentage of this Nation's employment, entrepreneural initiative, and increased productivity.

IDRB's are an essential economic development tool. We can state from our experience in Missouri that much of the progress that we have made in attracting manufacturing jobs has been assisted by IDRB financing. I have just come back from a trip to recruit European businesses to locate in the United States, to hire American workers rather than to serve the American market by exporting to

America. We found that IDRB financing is essential if many of the companies are going to build the plants and hire American workers to produce goods which previously have been exported to America.

Today I come before you to discuss with particular attention two proposals that Treasury has made—the first, the recommended revision of the tax laws affecting tax-exempt financing and IRS Revenue Ruling 81-216.

The Treasury has recommended an eight-part proposal to place restrictions on State and local nongeneral obligation tax-exempt bonds. It is our conclusion that the net effect of these measures would be to eliminate the further issuance of small issue industrial development bonds and severely restrict other types of revenue bonds in the out years of the proposal.

Congress has in the past exempted the interest on revenue bonds from Federal income taxation because the bonds are used to meet specific, valued, and important public purposes. State and local governments make a second determination prior to the issuance that the projects will confer a public benefit. These bonds, in our State and other States, are used for such public purposes as the construction of hospitals, educational institutions, low-income multifamily rental housing, airports, mass transportation, environmental, and energy facilities, as well as funding scholarships and the creation of jobs through construction of industrial plants and loans to small businesses.

One proposal that the Treasury has made would require businesses to choose between the benefits of tax-exempt financing and the tax savings from the accelerated cost recovery system. Preliminary analysis undertaken in our State and in the State of Mississippi, whose Governor, Governor Winter, is vice chairman of this committee, show that only those few firms with severe capital needs and poor economic prospects would choose IRB financing over the use of ACRS. These unprofitable or potentially unprofitable corporations would probably not be creditworthy. In our estimation the effect of the forced choice would be that few if any users of this financing would choose industrial revenue bonds.

The impact on IRB's issued under Internal Revenue Code section 103(b)(4) used to finance low-income multifamily rental housing would be particularly severe. Congress and the administration recently passed the Economic Recovery Tax Act to give special inducements for construction of low-income multifamily rental housing in addition to ACRS. The forced choice between revenue bonds and ACRS would eliminate the incentives just provided.

Second, another major limitation proposed by the Treasury is the requirement that governmental units issuing IRB's must make a financial contribution or commitment to the project.

While we do not fully understand what is meant by the phrase "financial contribution or commitment," we do know that this limitation could present enormous difficulties. A careful analysis of the impact of this proposal we feel is needed. We have heard that as many as 30 States, perhaps more, are barred by their State constitutions from supporting revenue bonds with either their full faith and credits or a guarantee. Specific examples we know are Missouri and the State of Colorado. We have also heard that Maryland is barred from offering tax abatement. It is our present impression

that contribution or commitment provisions would bar many States from issuing IRB's.

Finally, this proposal appears to assume that the States are not currently making a contribution to the supported projects. The Congressional Budget Office stated in its April 1981 study of small issue industrial revenue bonds that many States already are providing financial incentives. Most States, such as the State of Missouri, exempt the interest of such bonds from State income tax. And others exempt revenue bond-financed projects from property and sales taxes. Moreover, States and localities making sizable investments in infrastructure development make it possible for new construction to take place.

Third, while the rest of the administration and Congress is trying to reduce red tape and bureaucracy and to reduce Federal interference with the operation of State and local governments, the Treasury Department's proposals would add additional administrative burdens and reports for the issuance of these bonds.

Fourth, the Treasury would restrict the yields issuers of IRB's earn on bond proceeds during the temporary construction period, and on other funds. Once again, the Treasury does not appear to have measured the true impact of the proposed modification and here again it would have a substantial impact on the building of low-income multifamily rental housing.

Fifth, the Treasury would restrict small issue IDRB's to small businesses. It has not yet been demonstrated what need there is for this kind of limitation.

The Treasury recognizes that 84 percent of the dollar volume of IDRB's issued in 1978 and 1979 went to non-Fortune 1,000 industrial companies and to non-Fortune 50 non-industrial companies. Ninty-three percent of the small issue IDRB's went to medium and small sized companies. Further, there has been no demonstration of which we are aware why a capital expenditure limitation is proper, whether the capital expenditure data for making this judgment is available or why the proposed $20 million figure is appropriate.

Mr. Chairman, I would call your attention in a related area to one aspect of the Treasury's proposal to modify the corporate minimum tax. I understand that they would expand this to items of tax preference including tax deductions for interest of debt to buy or carry tax-exempt securities. If the minimum tax were to be extended to tax exempt interest of general obligation and revenue bonds issued by State and local authorities, the result in costs to the State and local governments for all bonds would be disastrous. Banks hold about 45 percent of the $328 billion of outstanding municipal bonds and are prime targets for the minimum corporate tax law.

It is our feeling that the demand for municipal bonds by the banks would decline 20 to 30 percent as a result of the Treasury's minimum corporate tax proposal. And we understand that the bond market is already showing some resistance to municipal obligations as a result of the proposal. On behalf of the Nation's Governors, I respectfully request that you not accept the Treasury's proposal to restrict tax-exempt bonds until you have had sufficient

time to hold separate hearings on the proposal and the opportunity to consider other responsible reforms.

We would hope that you would view the minimum corporate tax proposal as a significant opportunity to make State and local tax-exempt bonds much more desirable by exempting them from preference items required to be returned to the taxable income base—if in fact you do proceed with a minimum corporate tax proposal. Such action would enhance the attractiveness of tax-exempt bonds relative to other tax shelters and probably reduce the cost of such financing by State and local governments. The action might restore municipal bonds to their historic price relationship to corporate bonds.

We feel that the reduction by Congress of the individual and capital gains tax rates, the creation of the all savers certificates, and the creation of other tax shelters in the last year and a half have all contributed to the relative decline in attractiveness and increased the cost to States and localities of revenue bonds, as well as general obligation bonds. Now there is an opportunity for Congress to reverse the impact of its earlier actions.

As I said, the second part of our request today is respectfully to ask that you take immediate action to reverse the effect of Revenue Ruling 81-216 and its successor proposed regulation.

Since August 24, 1981 pool small issue industrial development revenue bonds have been dead in the water. Programs in 50 States and Puerto Rico are adversely affected; 22 States will lose valuable programs of assistance to small businesses and 17 will lose their agricultural development programs.

We believe pooling of small issues is necessary. We need access to the economies of scale in marketing and we need to have the issues guaranteed so that unrated firms can be assisted. We believe there is a need to deal positively with purchasers' needs for risk diversification in their portfolios. Revenue Ruling 81-216 precludes us from doing these things and as a result closes the door on many small businesses.

Finally, I would emphasize once again, Mr. Chairman, that we believe it is extremely important to preserve mortgage revenue bond financing for multifamily and single-family housing if we are to revive our severely depressed housing market.

Of all of the proposals to aid housing construction currently under discussion in the Congress simply removing the constraints imposed by the Mortgage Subsidy Bond Act of 1980, will have the most immediate and beneficial impact on the housing industry.

I would urge you to accept the amendments currently considered in conference in H.R. 4717. We believe we must have this financing vehicle available if we are to meet the goal of adequate affordable housing for all Americans and continue our commitment to the American dream of home ownership as an attainable goal for the American family.

We would make one final suggestion. The Mortgage Subsidy Bond Act of 1980, sunsets the single family bonds in 1983. Although the statute was enacted over 15 months ago, delays in the promulgation of regulation and flaws in the act itself have made it extremely difficult for States to issue bonds under the rules established by the act. Just 2 days ago Missouri made its first issuance

of single-family bonds since that act went into effect. We would urge that the sunset provision be extended to permit the States to make up for lost time.

I appreciate the opportunity, Mr. Chairman, to testify on these important issues. I trust that you will find the National Governors Association and the States responsive to your desire to arrive at mutually satisfactory solutions to make our partnership work better.

Thank you.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL GOVERNORS' ASSOCIATION

SUMMARY OF PRINCIPAL POINTS

1. The country is in a serious recession. Economic development programs are needed now as much as they have ever been. Industrial revenue bonds, and small issue industrial development revenue bonds in particular, are effective and essential economic development tools.
2. The Administration's restrictions are draconian, and in toto they will eliminate the further issuance of industrial development revenue bonds.
3. The minimum corporate income tax proposals will drastically and negatively affect the whole municipal bond market.
4. IRS Revenue Ruling 81-216 has shut out pooled small issue industrial development revenue bonds from the marketplace.
5. The Committee should reject the Administration's IRB proposed restrictions, consider IRBs separately from the overall revenue package, and hold additional hearings on possible reforms of IRBs.
6. The minimum income tax should not tax either the interest of tax exempt bonds or the debt to buy or carry such securities.
7. The Committee should approve language repealing IRS Revenue Ruling 81-216 and permitting the pooling of small issue industrial development revenue bonds.
8. The single family bond program authorized by the Mortgage Subsidy Bond Act of 1980 should be authorized beyond 1983.

STATEMENT

I am pleased to appear today on behalf of the National Governors' Association (NGA) to discuss the use of tax exempt financing by State and local governments. I am here as the Chairman of the NGA Committee on Community and Economic Development.

All of us know that the country is in a serious recession. Economists predict declines in the nation's Gross National Product in the first quarter of 1982 at annual rates of up to 4.7 percent. Estimates are that capital spending by business may drop as much as 4.5 percent. The Congressional Budget Office (CBO) expects interest rates to resume their rise during the economic recovery forecasted for the second half of 1982.

Nationwide housing starts dropped below 1.1 million units for the first time since 1946, and these low figures are likely to continue through 1982 as interest rates remain high.

Treasury Secretary Regan and Commerce Secretary Baldrige have recently predicted that the current recession will drive unemployment to as much as a 10 percent national rate this year, the highest level since World War II. The Labor Department recently reported that 19 States already had unemployment rates in excess of 10 percent in January.

The federal and State governments must work in partnership to bring our country back on the road to economic recovery. Both Congress and the Administration have called on the States to take on added responsibilities for community and economic development functions. We are willing, but we need the tools to do the job and the flexibility to use them appropriately.

States need economic development tools to stimulate job creation, encourage business expansion and increase productivity. When virtually all federal economic development programs are slated for termination, and many have been eliminated already, industrial revenue bonds (IRBs) become almost the only tool available for financing business development in economically underdeveloped or distressed com-

munities. In our present time of austerity, IRBs are a cheaper federal economic development program than the direct federal expenditure programs that are now being cut back, they are available to a large number of jurisdictions, they provide great local flexibility for matching funds with local economic needs, and they rely on the private marketplace for the lion's share of funding.

As you know, 47 States issue industrial revenue bonds. The principal beneficiaries of small issue industrial development revenue bonds (IDRBs), according to both the CBO and the Department of the Treasury, are small businesses. In fact, the primary utility of IDRBs is their effectiveness in increasing investment in small businesses that provide such a large percentage of this nation's employment, entrepreneurial initiative and increased productivity.

IDRBs are an essential economic development tool.

In Missouri much of the progress we have made in expanding manufacturing jobs has been assisted by IDRB financing. IDRBs have provided the means for capital formation which has not been otherwise present. The small issue IDRB financing has helped to create jobs and industry where none existed before. Without the availability of IDRB financing, I am convinced that many of the new plants would not have been constructed.

Today, I come before you to discuss two proposals of the Administration: its recommended revision to the tax laws affecting tax exempt financing and IRS Revenue Ruling 81-216.

The Treasury has recommended an eight part proposal to place restrictions on State and local non-general obligation tax exempt bonds. It is our conclusion that the net effect on these draconian measures is to eliminate the further issuance of small issue industrial development bonds and severely restrict other types of industrial revenue bonds in the outyears of the budget.

Congress has exempted the interest of industrial revenue bonds from federal income taxation because the bonds must be used to meet specified valid and important public purposes. Moreover, State and local governments make a second determination prior to issuance that the project will confer a public benefit. The bonds are used for such public purposes as (a) the construction of hospitals, educational institutions, low income multi-family rental housing, airports, mass transportation, and environmental and energy facilities, (b) the funding of scholarships, and (c) the creation of jobs and support for economic development through construction of industrial plants and businesses operated primarily by small businesses.

One proposal of Treasury requires businesses to choose between the benefits of tax exempt financing and the tax savings from the Accelerated Cost Recovery System (ACRS). Based on preliminary analyses undertaken by the State of Mississippi and my own State, only those few firms with severe capital needs and poor economic prospects would choose IRB financing over the use of ACRS. These potentially unprofitable corporations would probably not be creditworthy. In our estimation the effect of the forced choice would be few if any users of industrial revenue bonds. The impact of IRBs issued under IRC Section 103(b)(4) used to finance low income multi-family rental housing would be particularly severe. Congress and the Administration recently passed the Economic Recovery Tax Act giving special inducements for construction of low income multi-family rental housing in addition to ACRS. The forced choice between IRBs and ACRS would eliminate the incentives just provided.

Second, another major limitation proposed by Treasury is the requirement that the governmental unit issuing IRBs must make a financial contribution or commitment to the project. While we do not fully understand what is meant by the phrase "financial contribution or commitment", we do know that this limitation will present enormous difficulties.

A careful analysis of the impact of this proposal is needed. We have heard that as many as thirty States are barred by their State constitutions from supporting IRBs with either their "full faith and credit" or "guarantee". Specific examples are Missouri and Colorado. We have also heard that Maryland is barred from offering tax abatements. It is our present impression that the "contribution or commitment" provision will bar many States from issuing IRBs.

Finally, this proposal appears to assume that the States are not currently making a contribution to the supported projects. CBO stated in its April 1981 study of small issue industrial revenue bonds that many States are already providing financial incentives. Most States exempt the interest of such bonds from State income tax and others also exempt IRB financed projects from property and sales taxes. Moreover, States and localities make sizeable investments in infrastructure development to make it possible for new construction to take place. It is not a typical for States to prepare industrial sites, provide water and sewage connections and provide access

roads. Congress should have a study conducted on present State contributions before anything further in this area is required.

Third, while the rest of the Administration and Congress is trying to reduce red tape and bureaucracy and to reduce federal interference with the operation of State and local governments, the Treasury Department is proposing the following additional administrative burdens: (a) increasing the cost of issuance by requiring registration of industrial revenue bonds; (b) increasing the cost and time of issuance by requiring public notice of a public hearing and the holding of a hearing by both the issuing governmental jurisdiction and the political jurisdiction in which the financially supported facility will be located; (c) increasing the paperwork, delaying the processing and adding to the layers of review by requiring approval of the bonds by an elected official or legislative body in addition to the approval by the existing legally constituted and empowered issuing public agency or requiring separate approval by voter referendum for each supported facility; (d) increasing the cost by requiring public notice after the bond is approved; and (e) adding to the paperwork cost by requiring reporting by the State or local government to the Internal Revenue Service. (Permitting reporting by local governments directly to IRS rather than through the States will be inefficient for Treasury and will bypass State authority.)

Fourth, the Treasury would restrict the yields issuers of IRBs could earn on bond proceeds during the temporary construction period and on reserve funds. Once again, the Treasury does not appear to have measured the impact of its proposed modification. It is our judgment that this proposal might jeopardize the financing of the issuing agencies. But more importantly the individual projects directly supported by the bonds might be jeopardized due to the increased risk of not having sufficient reserves. Particularly in the building of low income multi-family rental housing where construction delays are endemic, the inability to earn market rate interest on funds during construction periods may make it impossible to cover increased inflationary construction costs that result from those delays. Moreover, the proposal fails to appreciate the risks involved in mortgaging and operating low income multifamily rental housing. Sufficient reserves, consisting of the original set-aside and earned interest, are needed to withstand the non-payment of rents and damage to property that frequently occur.

Fifth, the Treasury would further restrict small issue IDRBs to small businesses. The Treasury has not yet demonstrated the need for a limitation of this kind. Both the CBO study, already referenced, and Treasury acknowledge that the vast majority of IDRB issues go to small and medium sized businesses. In 1978 and 1979, 84 percent of the dollar volume and 93 percent of the number of small issue IDRBs went to medium and small companies (non-Fortune 1000 industrial companies and non-Fortune 50 nonindustrial companies). Further, there is no demonstration: (a) why a capital expenditure limitation is the proper criterion for a small business limitation, (b) whether the capital expenditure data for making this judgment is available, or (c) why the $20 million figure is appropriate.

The Treasury's suggested revisions especially target small issue industrial development revenue bonds. However, these securities currently are only a small portion of the tax exempt bond market. According to the Public Securities Association, only seven percent of long-term municipal bonds in 1981 were for industrial aid of which small issue industrial development revenue bonds were an even smaller portion.

In a related area, we are concerned about one aspect of the Treasury proposal to modify the corporate minimum tax. That provision would expand to the items of tax preference an addback of the existing tax deduction for debt to buy or carry tax-exempt securities. If the minimum tax were to be extended also to the tax exempt interest of general obligation and industrial revenue bonds issued by State and local governments, the results in the costs to State and local governments for all bonds would be disastrous. Banks hold almost 45 percent of the $328 billion of outstanding municipal bonds and are prime candidates for the minimum corporate tax. It is our understanding that the demand for municipal bonds by banks will decline by 20–30 percent as a result of the Treasury's minimum corporate tax proposal. In addition, we understand that the bond market is already showing some resistance to municipals as a result of the Treasury's proposed minimum tax proposal through the reduction of the current spread.

On behalf of the nation's governors, I respectfully request you not accept Treasury's proposal to restrict tax exempt bonds until you have had sufficient time to hold separate hearings on the proposals and have had the opportunity to consider other responsible reforms. NGA is concerned that the issue of IRBs will be lost in the issues of the larger revenue package which is currently under consideration. Further, we feel that we all should have a much better idea of what the likely impact of modifications will be before those changes are adopted. NGA would be

glad to cooperate with the Committee seeking improvements in the way IRBs are used.

We hope that you view the minimum corporate tax proposal as a significant opportunity to make State and local tax exempt bonds much more desirable by exempting them from the preference items required to be returned to the taxable income base. Such action would enhance the attractiveness of tax exempt bonds relative to other tax shelters, and probably reduce the cost of such financing by State and local governments. This action might restore municipal bonds to their historic price relationship to corporate bonds. The reduction by Congress of the individual and capital gains tax rates, the creation of the All Savers Certificates, and the creation of other tax shelters in the last year and a half have all contributed to the relative decline in attractiveness and increased cost to States and localities of municipals. Now there is an opportunity for Congress to reverse the impact of its earlier actions.

We respectfully request that you take immediate action to reverse the effect of IRS Revenue Ruling 81-216 and its successor proposed regulation. Since August 24, 1981 pooled small issue industrial development revenue bonds have been dead in the water. Programs in 50 States and Puerto Rico are adversely affected. Twenty-two States will lose valuable programs of assistance to small businesses, and 17 will lose their agricultural development programs.

Pooling of small issues is necessary. We need access to economies of scale in marketing. We need to be able to have issues guaranteed so that unrated firms can be assisted. We need to be able to deal positively with purchasers needs for risk diversification in their portfolios. Revenue Ruling 81-216 precludes us from doing these things and as a result closes the door on many small businesses.

Finally, I would like to mention the related question of mortgage revenue bond financing. The Mortgage Subsidy Bond Act of 1980 sunsets single family bonds in 1983. The statute was enacted over fifteen months ago. Yet delays in the promulagation of regulations and flaws in the Act made it extremely difficult for Missouri and other States to seek bids for bonds under the permanent rules established in that Act. Extension of the sunset provision would permit the States to make up for lost time.

We believe it is extremely important to preserve mortgage revenue bond financing for multi-family and single family housing if we are to revive our severely depressed housing market. Of all the proposals to aid housing construction currently under discussion, simply removing the unforeseen constraints imposed by the Mortgage Subsidy Bond Act of 1980 will have the most immediate and beneficial impact on the housing industry. I urge you to accept the mortgage revenue bond amendments contained in H.R. 4717. We must have this financing vehicle available if we are to provide affordable housing for all Americans and continue our commitment to the American dream of home ownership as an obtainable goal for America's families.

I appreciate the opportunity to testify on these important issues. I believe you will find NGA and the States responsive to your desire to arrive at mutually satisfactory solutions to make our partnership work better.

Chairman ROSTENKOWSKI. Thank you, Governor. I am sorry that I was late.

Are there any questions?

Mr. Pickle will inquire.

Mr. PICKLE. Mr. Chairman, it seems a bit strange to me, Governor, that in your effort to protect and to enlarge or continue the revenue bond program, you take the position that you would be against the action we took last year—that is, you seem to oppose the individual tax reduction, the capital gains rates, the all-savers certificates, and I presume the other tax incentive programs.

Is it that you are against those, or you just prefer the other approach, or you just want us to repeal this particular ruling that has been issued last August?

Governor BOND. Mr. Chairman, I thought my testimony was clear. I am sorry it wasn't.

The various tax incentives which have been provided have made the tax exempt or the industrial revenue bonds enjoy less of a favorable spread.

We have not said in any way, nor have I sought to imply, that the tax reductions were in any way undesirable. What we have said is with respect to one particular proposal, which is being widely considered. If you do impose a minimum corporate tax we would ask that you exempt the interest on State and local general obligation and revenue bonds so that they would once again enjoy the differential.

Mr. PICKLE. You do say that it has created a negative impact on the States—the bill we passed last year, the Economic Recovery Tax Act—and that it has hurt your State. I find that difficult to understand.

Did the Governors take an official position on this?

Governor BOND. No, sir; the Governors have said, and they continue to take the position that we must have industrial revenue bonds. Revenue Ruling 81-216 has killed the ability to pool small issues.

The Mortgage Subsidy Bond Act of 1980, until the Treasury issued its interpretation, killed the ability to issue mortgage revenue bonds. And it continues to restrict them severely. The Governors have opposed those restrictions.

Mr. PICKLE. Has my Governor endorsed this particular approach, do you know?

Governor BOND. The Governors' association went on record in support of this approach at its midwinter meeting held here in February, by unanimous voice vote.

I did not look around to see whether Governor Clements was in the room at the time. I assume he was. And there was no dissenting vote.

Mr. PICKLE. I thank you very much.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. Thank you.

Governor, I don't know of any serious proposal to put tax exempt interest under the minimum tax. But there is a serious proposal to put the carrying costs for loans used for the purpose of buying tax-exempt bonds under the minimum tax. And your feeling is that that in itself would affect the market.

Certainly it would affect the desirability of banks borrowing money to buy tax-exempt bonds. And that is what banks do, and banks are, as you say, a major purchaser of tax-exempt bonds.

You understand that distinction. You still think it would be damaging to the market, I take it.

Governor BOND. Yes, sir.

Mr. CONABLE. Last year for the first time the issuance of tax-exempt bonds for private purposes exceeded the issuance of tax-exempt bonds for public purposes. I am wondering if the proliferation of such issuance doesn't have a greater impact on the marketability of tax-exempt bonds than almost anything we do with the tax law here.

Governor BOND. It apparently has approached the level where the various revenue bonds would equal the issuance of general obligation bonds.

First of all, I would question your suggestion that issuance of bonds for industrial development, for housing, or financing, other socially desirable purposes, constitutes a private purpose.

Mr. CONABLE. They obviously are private beneficiaries—even though there has to be some nexus with the public purpose. Usually the purchasers of single family mortgages are private people.

Obviously the industries that occupy the plants built with IRBs and so forth are private industries, profitmaking industries.

There is, in other words, the ultimate purpose, and the ultimate beneficiary is private even though it may be issued with a public purpose behind it.

I am just wondering: What brings about the destruction of the normal spread between tax-exempt and taxable bonds. And I am afraid one of the reasons is the proliferation of tax-exempt bonds for whatever purpose.

Governor BOND. Mr. Conable, there are other things that have been adopted by Congress recently, such as the all savers certificates, and other various tax changes that have, as I indicated in my testimony, made the tax-exempt bonds less attractive as an investment vehicle.

The figures that I had previously cited showed that industrial development revenue bonds only amounted to about 7 percent of the total issuance.

We are obviously looking at some different figures. I will have to check our figures against the figures that you have. But the bonds of which we are particularly interested, industrial development and mortgage revenue subsidy bonds, constitute only a very small part.

When you compare that with the overall effects and benefits of revenue bonds with the effects and benefits of the all-savers certificates, we think the impact of it is minimal.

Mr. CONABLE. Well, obviously whatever the statistics, the Governors are not concerned about conventional tax-exempt financing, if they feel that continuance of current trends is not impinging on it.

Governor BOND. According to the Public Securities Association, in 1981 only 7 percent of long-term municipal bonds were for industrial aid. That seems to me to be a very, very minimal impact on the overall spread.

We believe that spread in financing is a result of other factors which are not related to the issuance of the bonds that we speak of here today.

Mr. CONABLE. I will have to check my figures, too, Governor. I appreciate that.

We have had the impression here that use of such bonds for unconventional financing rather than traditional municipal investment purposes, that is in municipal services, was growing at a rather alarming rate.

We will check our figures, too.

Governor BOND. We would submit to you a study by Professors Kormendi and Nagle of the University of Chicago called "The Nature and Effect of Small Issue Industrial Bonds," which finds that the effect of each additional $1 billion of tax-exempt bonds is a rise in only 0.6 of a basis point in tax-exempt interest rates. And

this is far smaller than other figures which have been widely quoted.

We would urge that the Congressional Budget Office review these studies from the University of Chicago in determining what the impact is.

Mr. CONABLE. Thank you.

Chairman ROSTENKOWSKI. Mr. Gephardt will inquire.

Mr. GEPHARDT. Thank you, Mr. Chairman.

Thank you again, Governor, for being here and taking the time to talk to us about these bonds from the Governors' standpoint.

I would like to ask three questions. One, you mention in here a Treasury study that is supposed to be done or apparently has been done on the financial implications of having to choose between the use of IRB's and ACRS, accelerated cost recovery. Has that study been done, and are you aware, if it hasn't, when it will be done?

Governor BOND. We were advised by the Treasury officials who spoke to the National Governors Association meeting in February that such a study had been done. Frankly, it was counter to everything that we had heard and everything we had seen in our States, and we asked for a copy of that study.

We have not yet received it. So I don't know what its status is, and I cannot comment on it.

Mr. GEPHARDT. Do you know what the study was about? Was it a study to tell someone what would happen if this trade-off were established in the law?

Governor BOND. We were told that it was a study showing that requiring a trade-off between industrial revenue bond financing and the benefits of accelerated cost recovery system would not substantially impede the issuance or the use of the IDRB's. That statement was made to us orally. To the best of my recollection the Treasury officials merely stated that the study proved that there would not be a significant chilling effect on the use of IDRB's.

As I said, that conclusion is contrary to the information we gained in our informal surveys, and we asked to see a copy of that report. We have not seen it.

Mr. GEPHARDT. In other words, you had lots of evidence in your State and in other States that this would have a very chilling effect on the use of IRB's, that people—especially firms with low capital would be forced to choose the ACRS and would not be able to use the bonds; is that correct?

Governor BOND. That's correct. Basically we had to go to the people who were either involved in working on bond issues or the people who would be utilizing the bonds themselves. We tried to ask the question as objectively as we could.

The overwhelming view of those people involved was that there would be a significant chilling effect. It is not a scientitic double-blind sample study. But it is the best assessment that we could make.

Mr. GEPHARDT. The second question has to do with the second requirement that concerns you, that there be a commitment from the local or State government.

I think the phrase is financial contribution or commitment.

Your testimony seems to indicate that you don't understand what kind of commitment is being asked for. I take it the specifica-

tions for the legislation, or the legislation itself, do not yet spell that out. Is that correct?

Would that be left to regulations or something?

Governor BOND. To my knowledge, we have not seen a copy of the legislation. We have been unable to look at it and to review it.

As I indicated, Mr. Gephardt, in Missouri we do exempt the interest. So we feel that we are making a commitment.

Now, we don't know whether the Treasury seeks to spell out in law that there should be some cash payment made in addition to the exemption of interest, or whether the relaxation of the tax burdens that the State or local governments apply would be adequate. Until we know that, we have to express the reservation that a direct payment to the user of the bonds would probably be barred by our constitution in Missouri.

Mr. GEPHARDT. What would be the case, then, in States where it wasn't barred by the constitution if they required, say, a 10-percent direct payment into the deal by the State and local government?

What do you think would be the effect of that?

Governor BOND. Reserving our right to argue in court, if we have to, that it would not be barred by the constitution, I think we have very real adverse problems with our constitution in that situation.

Mr. GEPHARDT. One last quick question. You mentioned mortgage revenue bonds for single-family housing and multifamily housing at the end of your testimony. Can you tell me what the situation is in Missouri and many other States with regard to those bonds issues at this point?

Have you gone forward with bond issues under that act?

Governor BOND. On March 31, the Missouri Housing Development Commission sought bids for $50 million in bonds for single-family units. We could do so only because of the Treasury's interpretation in late 1981 allowing us to meet the 95-percent requirement. Missouri was able to go ahead because the Missouri Housing Development Commission is very sound financially and it was able to use its reserves to better the arbitrage requirements. Communities or States without those reserves cannot do so.

Mr. GEPHARDT. Thank you very much. And thank you again for being here.

Governor BOND. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Fowler will inquire.

Mr. FOWLER. Governor, I welcome you.

Do you happen to know whether the National Governors' Association has made a study of the President's recommendation on urban enterprise zones, or are you in the process of doing that?

Governor BOND. Mr. Fowler, we are pursuing enterprise zones in our NGA committee. In our State of Missouri we are working toward a State Enterprise Zone Act. I have personally visited with the officials in the United Kingdom who are responsible for enterprise zones. While we know a little bit about the enterprise zone activity there, and have our ideas, we have not done a detailed study. Our committee is continuing to review the Enterprise Zone Act proposals.

Mr. FOWLER. Well, I am interested for a lot of reasons. I represent Atlanta. I am interested on behalf of the cities, certainly in

the concept, and certainly as we pursue the President's recommendations in these areas.

But it seems to me, without having studied the matter, that there is a relationship or should be a relationship looked at between what we are referring to as urban enterprise zones, the objectives within urban enterprise zones, and the objectives of the industrial revenue bond program.

Do you make that relationship in your mind? If the industrial revenue bond program was working the way it is supposed to work, with the public policy objectives that you described, is that not a precursor of urban enterprise zones?

Governor BOND. Speaking for myself, and my administration, not for the National Governors Association, we have recommended that this committee and Congress impose certain restrictions. These restrictions, however, should not be applied in enterprise zones because, in fact, you are in my opinion correct that the kind of assistance that Enterprise Zone Acts would provide is similar to the assistance that industrial revenue bonds have provided to create jobs and get people to work. That is the objective as I understand it of the enterprise zones, I think that the two can come together, and the two concepts can be utilized together.

Mr. FOWLER. Well, I am glad to hear that. I eagerly await the study that you and the Governors are doing.

We all want to certainly rid ourselves of the documented abuses in the industrial revenue bond program. And we have been frustrated by trying to clean it up without throwing the baby out with the bath water. But I am also concerned that when—if we all of a sudden—that we are not just going to reorganize the table of contents to have a new program with a new name when we have something that might be part and parcel of what we are trying to do in urban enterprise zones if we can make sure it is done right, done cleanly.

Governor BOND. Mr. Fowler, on behalf of the Nation's Governors I would say we are more than willing to work with you. We appreciate this opportunity.

We look forward to discussing with you any suggestions for eliminating the abuses. We understand the need for it. We will do that.

With respect to the enterprise zones, however, I cannot say that there is any hard, conclusive data that I will be able to give you on enterprise zones unless and until we can get our legislation underway in Missouri. We await the impact of the Federal legislation.

It is my personal view that it will help. But, again, outside of the British experience which has been successful, I have no way of knowing what its impact will be.

Mr. FOWLER. Thank you very much.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Governor Bond.

Governor BOND. Mr. Chairman, thank you very much for your hospitality.

Chairman ROSTENKOWSKI. Our next witnesses are Mr. Perlman, Mr. Berman, Mr. Cherecwich, and Mr. May.

Welcome to the committee, gentlemen. We appreciate the fact that you have taken time from your schedule to join us to discuss the President's tax proposals.

It is customary here that if your statement is longer than the time allotted to you that your entire statement will be included in the record. We ask that you summarize your statements so that we may discuss it with you.

We will start with Mr. Perlman and proceed in the order in which I called your names.

Mr. Perlman, if you will identify yourself, you may proceed with your statement.

STATEMENT OF ROBERT PERLMAN, TAX DIRECTOR, INTEL CORP., ON BEHALF OF THE SEMICONDUCTOR INDUSTRY ASSOCIATION

Mr. PERLMAN. Thank you very much, Mr. Chairman.

Good morning. My name is Robert Perlman. I am tax director of Intel Corp., headquartered in Santa Clara, Calif. Intel is an independent semiconductor manufacturing company with annual sales currently of $800 million per year.

I appear before you today representing the 55 companies of the Semiconductor Industry Association [SIA].

The U.S. semiconductor industry, the world leader in technology and market share, is under severe pressure from the current recession and foreign competition. During 1981, revenues decreased slightly and profits were down dramatically. However, the industry must continue to invest in research and development and in new equipment at a record pace. Otherwise the U.S. manufacturers could be caught without the technology or capacity to deliver products which will be demanded when world economies recover.

The world environment today reflects the views of many countries that high technology should be developed internally for export. This view reflects the goals of the U.S. industry and hopefully the U.S. Government.

The goals I refer to are: (1) Perform R. & D. in the United States; (2) maintain U.S. leadership in high technology; (3) export manufactured products; and (4) whenever feasible create jobs in the United States.

The present tax law reflects these goals and enables U.S. semiconductor manufacturers to compete.

We believe any new tax proposals, including any broad-based alternative corporate minimum tax, should be considered in light of these goals.

It is crucial in considering revenue-raising proposals that the tax laws do not make it impossible or unduly difficult for us to operate effectively in the United States.

We think it is important to comment on five items which have been suggested to increase revenues.

R. & D. EXPENDITURES

The R. & D. tax credit enacted last year should not be modified. The credit can be a major factor in generating substantially increased R. & D. in this country. It should be given a chance to work. If the credit is cut back a message is transmitted to do your research elsewhere. Other countries would be overjoyed at this

result. Any adverse effect on the treatment of R. & D. can only impair our international competitive position.

EQUIPMENT INVESTMENT

If this committee will consider reducing ACRS benefits or if some preference for ACRS deductions is included in a minimum tax, the proposal must at least acknowledge the fact that the equipment of high technology companies depreciates over a very short period—3 or 4 years.

If depreciation of this equipment is permitted only over some longer period, or if the investment tax credit is not allowed against any minimum tax, the message would be to manufacture elsewhere—so that the cost of equipment could be recovered more rapidly and the funds be available to replace the equipment at the end of its useful life.

FOREIGN TAX CREDIT

If foreign taxes are not allowed as a credit against any minimum tax or if the credit for foreign taxes against the regular corporate tax is modified, the result could be double taxation, the very thing the foreign tax credit exists to prevent.

My company repatriates virtually all of its overseas sales profits, notwithstanding the present difficulties in obtaining a full credit. If no foreign tax credit is permitted against the minimum tax, it would then be beneficial to invest these profits overseas rather than repatriate them to pay for U.S. plants and equipment.

DISC

The deferral of DISC income has been suggested as a minimum tax preference item. If this income is included, a valuable stimulus to export might be removed, making U.S. industry less competitive in the international arena.

POSSESSIONS CORPORATIONS

If the earnings of possessions corporations are subjected to a tax in the United States, the competitive advantage of that part of the United States will fall substantially in comparison to Southeast Asia or Latin America. Plans for additional plant capacity within Puerto Rico would be disadvantaged.

We operate in a very volatile marketplace that other governments have targeted as one they wish to dominate. Semiconductor companies, for the most part, pay little or no dividends and utilize their profits for research, plant capacity, and increasing overseas market share.

In order to land in such an environment it is essential: (1) That the U.S. Government recognize other governments offer substantial tax incentives; (2) that the United States must itself offer a reasonable level of tax incentives; and (3) that the ground rules for those tax incentives not change every year. We must be able to plan with reasonable certainty.

We do not oppose all tax increases or even all increases that affect our industry. Instead, we stress to you the effects and likely results of our industry of certain proposed legislation.

We urge you to allow us to manage our business in a stable environment free from frequent reversals in tax policy and in a manner consistent with the common goals of our member companies and the United States.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Perlman.

[The prepared statement follows:]

STATEMENT OF ROBERT PERLMAN, TAX DIRECTOR, INTEL CORP., ON BEHALF OF THE SEMICONDUCTOR INDUSTRY ASSOCIATION

Good morning, Mr. Chairman. My name is Robert Perlman. I am Tax Director of Intel Corporation, headquartered in Santa Clara, California. Intel is an independent semiconductor manufacturing company with annual sales currently of $800 million per year.

I appear before you today representing the 55 companies of the Semiconductor Industry Association (SIA).

Our purpose today is to describe for you the effect of the Administration's tax proposals, and other tax proposals pending before you, on the U.S. semiconductor industry and on the ability of U.S. semiconductor companies—and other U.S. high technology companies—to compete in international markets. But first I would like to take a moment to describe for you the current state of the U.S. semiconductor industry.

THE U.S. SEMICONDUCTOR INDUSTRY

The U.S. semiconductor industry has been the world leader in semiconductor products both in terms of technology and market share. However, the current recession in the United State has seriously eroded the sales and, in particular, the profitability of these U.S. companies. This comes at a time when the position of the U.S. industry is already under a severe challenge from Japan and to a lesser extent from the Western European nations.

Despite the current recession in the United States and elsewhere, the worldwide semiconductor industry is expected to undergo explosive growth during the 1980's not only in sheer volume but also in the diversity of market applications. In 1980, world consumption of semiconductors reached $16.1 billion including both unrelated and related party uses. The world semiconductor industry supports approximately a $200 billion electronics equipment market. Industry analysts predict that the world semiconductor volume will reach or surpass $50 billion before the end of this decade and will support a world equipment market of over $500 billion.[1]

The U.S. semiconductor industry in 1980 accounted for 63 percent of world consumption, compared to 22 percent for the Japanese industry, and 12 percent for the European industry. By 1982, however, international competition has become much more evenly matched than 1980 overall market share data would indicate. The Japanese, who only began to export integrated circuits to the United States in volume in the mid-1970's, have achieved significant market shares in the United States for a whole array of advanced large scale integrated circuits (LSI) products. Currently Japanese industry holds 42 percent of the 16K dynamic RAM (random access memory) market and over 70 percent of the 64K dynamic RAM market. Futhermore, at a recent technical conference in San Francisco, all five technical papers on the 256K RAM, which will probably be the workhorse memory circuit of the late 1980's, were Japanese. These large memory circuits are the "flagships" of semiconductor technology. Moreover, because they are growing at over three times the rate of all semiconductors, sustained leadership in these commodity products will mean long-term market leadership.

In 1980, virtually 50 percent of the worldwide semiconductor volume was consumed outside the United States. In the quarter century history of the industry, the U.S. merchant industry has fiercely competed in all markets worldwide and currently sells 35 percent of its production outside the United States; if historical

[1] The semiconductor industry with advancing technology will account for a continued increase in percentage of equipment value from 8 percent in 1980 to 10 percent by the late 1980's.

trends were to continue, there is reason to believe that within 10 to 15 years, 45 percent to 50 percent of U.S. company sales would be in international markets.

Success in worldwide competition is determined by a company's innovation rate and the advancement of technological complexity. As recently as 1970, the semiconductor industry was producing memory circuits containing 1,000 elements of memory. At present, the industry is commencing production of a dynamic RAM with 64,000 elements on a chip, and by 1989, industry sources speculate that the most advanced chips will contain over 1 million elements.

These high levels of growth and increasing complexity cause dramatic increases in the requirements of U.S. semiconductor companies for new capital. The U.S. semiconductor industry's investment in short-lived process equipment and in R. & D. is now 28 percent of sales, compared to the U.S. industry average of 7 percent of sales. To finance this investment the industry must constantly generate fresh capital. Indeed, the industry's principal challenge is the availability and cost of its capital.

This is not a problem shared equally by the major foreign producers of semiconductors. American companies have a significantly higher cost of capital than the Japanese semiconductor manufacturers, and potentially the Europeans as well, with whom they much compete. A 1980 study prepared by Chase Financial Policy, a Chase Manhattan Bank subsidiary, revealed that the cost of capital of the typical American semiconductor company averages 17.5 percent, compared to only 9.3 percent for the Japanese competition. The study also revealed that, although American firms are compelled to earn a rate of return approximately equal to the cost of capital, currently 16.3 percent on operating capital, the Japanese companies fall short of covering capital costs with a return of only 7.5 percent.

In the long term, this structural advantage—lower cost of capital and current profit indifference—will work to the distinct disadvantage of American firms, jeopardizing their ability to earn sufficient return to cover capital cost and therefore their ability to compete.

Yet, the support of Japan and other countries for their semiconductor and computer industries goes beyond the relative cost of capital. It includes direct subsidies, research tax incentives and cartels, a sheltered domestic market, accelerated depreciation, soft loans and high leverage. This type of Government support amounts to a tacit guarantee to investors and results in virtual indifference by shareholders and creditors to low short-term profitability.

The ability of U.S. semiconductor companies to compete internationally has been significantly set back by the the current recession. For 1981, revenues from most semiconductor products increased by very small amounts compared to historic trends, if they increased at all, and profits were down dramatically. The picture for 1982 is slightly better. However, the U.S. industry is continuing to invest in R. & D. and in new equipment at a record pace. The industry does not want to be caught without the technology or the manufacturing capacity to deliver the volume of products which will be demanded once the economies of the world begin their recovery.

The 1981 Economic Recovery Tax Act provided significant incentives for our industry to expand its investments, particularly in research and development activities. We appreciate the efforts made by the members of this Committee last year in helping to enact these proposals. We hope that by working with you in the future, we can together improve the incentives and apply them to increase the levels of investment and R. & D. undertaken by U.S. corporations.

1982 TAX PROPOSALS

For many semiconductor manufacturing companies, the Administration's 1982 tax proposals and variations of those proposals which have been discussed by members of this Committee and others can have a seriously detrimental impact on the incentives enacted last year. We believe it important to bring this impact to your attention. The fact that we do so, however, does not mean that we oppose all tax increase proposals or that we even necessarily oppose all proposals which might increase the tax liability of SIA-member companies. However, we do believe that, in fashioning any tax proposals for this year, certain general principles ought to be followed.

THE NEED FOR STABLE TAX POLICIES

First, for any tax policies to have an impact on corporate planning, they must be available over a relatively long period of time. My company, like most companies, is today making investment, marketing and other planning decisions that will affect our company's operations three, four and five years from now. If the tax incentives now in place are to have an impact on those planning decisions, as Congress intend-

ed in enacting them, we must have some degree of certainly that incentives will continue to be part of the tax laws at least for the near future.

Example of DISC.—Current proposals relating to the DISC provisions provide an important example of the effect of legislative uncertainty. Intel, like most semiconductor manufacturing companies, exports large volumes of products from the United States and also engages in substantial foreign manufacturing. Decisions to export or manufacture abroad are, of course, influenced by any number of factors. Among these factors is the U.S. tax treatment of exports. For the past ten years the United States has through the DISC provisions encouraged U.S. companies to export rather than manufacture abroad. Yet in planning for the future, the status of DISC benefits has during the past year become uncertain. On the one hand there has been talk in the Treasury Department and among some Congressional staff of repealing DISC. On the other hand, Executive branch officials have publicly considered repealing DISC and replacing it with a similar and somewhat more generous incentive. And now the Administration proposes subjecting DISC benefits to its alternative corporate minimum tax, which for Intel and other semiconductor manufacturing companies could significantly erode the DISC benefits currently received. In such an environment it is difficult for any company to determine whether substantive U.S. tax benefits for export activities will continue or whether from a tax viewpoint future advantages will arise for manufacturing abroad. This must be considered along with the significant tax incentive advantages consistently provided by other countries.

THE NEED FOR THE CLEAR AND CERTAIN APPLICATION OF EXISTING POLICIES

Our second general principle is that, if incentives are to be continued in the future, they should not be provided in a half-hearted or uncertain manner. That, in our view, is the fundamental problem with adopting a corporate alternative minimum tax to raise revenues: it substantially increases the degree of uncertainly for any company attempting to determine its ability to take advantage of existing tax incentives in future years.

Minimum tax and the R. & D. credit. The effect of the corporate alternative minimum tax on the R. & D. credit provides a simple illustration of this point. The purpose of the credit is to provide an incentive for increased R. & D. activities by lowering the after-tax cost of increased expenditures for R. & D. However, a company attempting to determine what R. & D. projects it will fund in 1983 (the first year the Administration's minimum tax would be effective) cannot necessarily determine whether or not the credit will be available with respect to any increases in R. & D. in that year. If the company believes it will be sufficiently profitable in 1983 so that its effective regular tax rate (after all credits) will exceed 15 percent of its taxable income, it can assume that it will obtain the benefits from the credit. However, if a company for 1983 believes it could have a low level of profitability or if it just isn't sure in a highly volatile market place, so that its R. & D. credits, when combined with its investment and other credits, could reduce its corporate tax liability below 15 percent, the company could lose part or all of the 1983 benefit of the R. & D. credit under the proposed corporate minimum tax.

Yet, if the company projects that it could have losses instead of profits in 1983, the company may again be able to obtain the benefit of its R. & D. credit in 1983, because (as we understand the Administration's proposals) the credit can be carried back to pre-1983 years and allowed to reduce tax liability in those years without regard to the minimum tax. Thus, particularly in years of economic uncertainly, the corporate minimum tax substantially increases the difficulty of the financial planner or the tax manager in attempting to project the impact of the credit, and other tax incentives, on their corporation.

UNINTENDED AND DETRIMENTAL IMPACT OF PROPOSALS

The third general point we wish to make is that in considering tax increase proposals, this Committee should avoid any "quick fix" proposals to raise revenues at the expense of long-standing tax or economic policies without a careful consideration of the complete implications of those proposals. This point can be illustrated by a review of the impact of the Administration's tax proposals, including the corporate minimum tax, on companies with short-lived assets.

Administration proposals and short-lived assets.—Under the Accelerated Cost Recovery System (ACRS) enacted last year, most equipment is required to be depreciated over five years. Part of the rationale for enacting ACRS was the simplification which could be achieved by abandoning the concept of useful lives with respect to equipment depreciation. Moreover, ACRS obviously provides substantial benefits for

long-lived equipment. However, for shorter lived equipment, such as most of the equipment of semiconductor manufacturing companies, under ACRS depreciation deductions were decreased, not increased.

Let me emphasize this point, because it is not generally understood. With respect to much of the equipment of semiconductor manufacturing and other high technology companies, ACRS decreased rather than increased many companies' depreciation deductions for tax purposes. More importantly, under ACRS the depreciation deductions permitted for tax purposes is, for most high technology companies, now smaller than the depreciation expense required for financial reporting purposes; indeed, the deduction is significantly smaller than the amount of true depreciation that arises with respect to most equipment under any economically realistic measure of such depreciation.

In my own company, most of our manufacturing equipment is depreciated over four years for financial reporting purposes; others may use even a shorter life. In many ways our company would prefer to use longer lives for financial reporting—that would be one way to increase our reported earnings to our shareholders. However, in fact our manufacturing technology changes at a sufficient rate that much of our equipment becomes technologically obsolescent within a period of time that approximates three or four years. Thus, a three- or a four-year life reflects economic reality. Nonetheless, for tax purposes the equipment is assumed to have a five-year life.

Our company and high technology companies generally did not object to the fact that under ACRS depreciation deductions were required to be smaller than deductions which would reflect true economic depreciation; ACRS was a package of depreciation and investment tax credit proposals and provided a significant increase in the investment credit for equipment depreciated for tax purposes under prior law over three or five years. Taking into account the changes in the investment credit, most high technology companies were at least no worse off under ACRS than under prior law.

However, the Administration's 1982 tax proposals indicate that the adoption of the ACRS provisions and the abandonment of the concept of useful life have a tax impact beyond the direct measurement of depreciation deductions for regular tax purposes subject to investment credit offset. For example, under the Administration's proposal ACRS depreciation deductions are utilized in measuring income to be subject to the corporate minimum tax while no investment credit offset is permitted. For companies with short-lived equipment, this feature of the proposal has a perhaps unintended impact: their depreciation deductions for minimum tax purposes are generally smaller than the amount which would be properly deductible in measuring economic income. Presumably, the concept behind the Administration's minimum tax proposal is that each company should pay some tax on their "real" income. However, it is unlikely that the Administration or any member of this Committee intends that a company be required to pay minimum tax even where a company has no real or economic income. Yet, that is exactly what can happen under the Administration's proposal with respect to companies with short-lived equipment.

A second example of the detrimental and presumably unintended impact of the disregard of actual useful lives for short-lived equipment appears in the Administration's proposals with respect to industrial development bonds. Some semiconductor manufacturing companies, and certainly many electronics companies generally, have been significant users of small issue industrial development bonds. They have provided one way for new and expanding companies to obtain the financing necessary to establish new facilities in communities across the country. The Administration proposes to limit the benefits of these provisions through a number of proposals. One proposal is to deny ACRS depreciation deductions to equipment financed with tax-exempt industrial revenue bonds. Instead, such equipment is to be depreciated on a straight-line basis over 12 years. Presumably, this provision was intended to deny taxpayers utilizing industrial development bond financing any additional tax incentive under ACRS. However, as described above, short-lived equipment of high technology companies receives no such special benefit under ACRS. By forcing high technology companies to depreciate their equipment over 12 years to the extent purchased under industrial development bond financing, the Administration is proposing a series tax penalty on these companies.

POSSIBLE COMMITTEE TAX PROPOSALS

The above comments apply not only to the Administration's proposals but to possible expansions of those proposals by this Committee. We understood that at least some members of this Committee may be contemplating an extension of the Admin-

istration's corporate minimum tax proposal by adding various other items of preference for that tax and that other members are considering some direct cutbacks in various incentives voted last year. We would like to take a moment to comment on the impact of at least some of these proposals.

Deductibility of R. & D. expenses.—We understood that the Committee may consider requiring some portion of R. & D. expenses to be amortized over a period of time rather than deducted currently for purposes of any corporate minimum tax. We would oppose any such proposal in the strongest way possible. It is our firm belief that the expansion of private sector R. & D. activities is essential to the competitiveness of U.S. companies in international markets and for increases in the productivity of American workers. Any minimum tax proposal which treats R. & D. costs in a detrimental fashion would provide a significant disincentive for new R. & D. expenditures. Surely such a disincentive cannot be good economic policy at any time and is particularly inappropriate now.

Moreover, there are strong tax policy, as well as economic policy, arguments against such a proposal. For virtually all accounting purposes—including financial as well as tax accounting—R. & D. expenses have traditionally and consistently been allowed as a current expense or deduction. Expenditures for R. & D. activities are not like expenditures for equipment or even like expenditures for drilling an oil well. Admittedly, sometimes R. & D. expenditures result in the creation of a specific asset (e.g., a patent or technical "know-how"); other times they result in nothing at all or nothing more specific than a generally increased body of knowledge. Thus, any determination of what, if any, R. & D. expenditures are related to which, if any, specific assets is inherently unclear and uncertain. For this reason, distinguishing between R. & D. which is properly expensed (because it does not give rise to any specific asset) and R. & D. which conceivably should be amortized is literally impossible. Thus, any proposal to require the amortization of some portion of R. & D. expenditures for minimum tax purposes would create either an impossibly complex provision or an arbitrary provision which could cause major distortions.

R. & D. credit.—It is our understanding that the Committee may also consider some modification to the R. & D. credit to raise revenues. In our judgment such an action would be counterproductive. The credit was just enacted last year and will not be fully phased in until 1983. It is to expire after 1985. The existence of the credit has been widely publicized; its benefits are beginning to be taken into account in corporate financial planning. We are confident that by 1985 sufficient evidence will be available to establish that the credit has been (and can continue to be) a major positive force in increasing the level of corporate and university R. & D. in this country. However, at this time, of course, no data exists to establish the effectiveness of the credit. Thus, it is in our view premature for this Committee now to consider any significant modifications to the credit. Once the data for a few years exists, the credit can and should be reviewed. But for now we urge you to give the credit a chance to work.

Minimum tax and foreign tax credit.—We understand that some members of this Committee may be considering a requirement that foreign taxes be treated as a deduction and not as a credit for purposes of any alternate corporate minimum tax. Again, we would strongly oppose such a proposal. The semiconductor industry can only be competitive in the United States if it is competitive in worldwide markets; the continual cost reductions that are crucial to a U.S. company's ability to compete can only be obtained by manufacturing and selling in volumes permitted by worldwide rather than merely U.S. markets. If foreign taxes were disallowed as a credit for any U.S. tax purpose, the ability of U.S. companies to compete internationally could be adversely affected. Companies from other countries without exception either pay no tax in their home country on their foreign income or at the very least are allowed a credit for their foreign taxes. If no foreign tax credit is allowed in the United States, U.S. companies would be required to bear a double tax (the local country tax and a U.S. tax) on their income. That would mean lower profits and, in a price-competitive industry, fewer sales outside of the United States and, thus, ultimately lower profits and fewer sales within the United States as well. Although denying the foreign tax credit for corporate minimum tax purposes might in the short-run raise a small amount of revenue for the Federal Government, with respect to the semiconductor industry it could in the long-run lead to a decline for the industry and thus a reduction in Federal tax revenues.

Income from possessions corporations.—There have also been indications that the Committee might consider modifying the possessions corporation provision or subjecting the income of possessions corporations to proposed minimum tax. Any such provision could seriously erode the incentives for U.S. corporations to invest in Puerto Rico and could have a substantial impact on the Puerto Rican economy. The

existing incentives have attracted to Puerto Rico a large number of investments that might otherwise have been made in foreign countries. Thus, it would seem counterproductive for the United States to enact legislation which would reduce, if not eliminate, the relative advantages of investing in Puerto Rico.

ACRS deductions.—Finally, it is our understanding this Committee is seriously considering reducing the benefits of ACRS or including some portion of those benefits as a minimum tax preference. While we offer no view on the merits of any such proposal in general, we urge that, if any proposal is considered, the circumstances of companies with short-lived equipment be taken into account.

For example, if some preference with respect to ACRS deductions must be considered as part of an alternative corporate minimum tax, the preference must be limited to any deductions permitted under ACRS in excess of some measure of economic depreciation. Thus, the preference could be either (1) the amount of any ACRS deduction in excess of the depreciation deduction allowed under the straight-line method over some arbitrary period (such as eight years) or, if less, (2) the excess of the ACRS deduction over the depreciation deduction that would be allowed using actual useful lives (and depreciation methods) adopted for financial purposes by publicly held companies or, in the case of privately held companies, for tax purposes prior to the 1981 Act.

CONCLUSION

We urge that, whatever tax proposals this Committee decides to adopt this year, the proposals affecting business tax incentives should not be adopted as temporary palliatives for our short-run economic problems. Rather, the proposals should be consistent with the longer-run strategy of economic and business growth implemented in the 1981 Act. Only in this way can companies have the ability to plan for the future in these uncertain times.

Chairman ROSTENKOWSKI. Mr. Berman, you may proceed.

STATEMENT OF GEORGE M. BERMAN, CHAIRMAN AND PRESIDENT, UNITRODE CORP., ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION

Mr. BERMAN. Mr. Chairman, I am George Berman, chairman and president of Unitrode Corp. of Lexington, Mass. We have electronics plants in Massachusetts, New Hampshire, Maine, and California, and employ 2,000 people. Sales last year were $112.5 million. And we devoted $6 million to R. & D. last year.

I appear before you this morning on behalf of the American Electronics Association, our country's largest association of high technology firms. Our members manufacture semiconductors, components, computers, instruments, communications, and defense products and systems. Like the electronics industry itself, AEA's membership contains many more small firms than large. Of our 1,900 plus members in 43 States, 80 percent of them employ 500 people or less.

We are not here to oppose any tax increase under any circumstances, including tax increases that affect AEA member companies. We recognize the danger to economic recovery caused by high interest rates and huge Federal deficits. At the same time, we believe that this committee should carefully tailor its revenue-raising efforts in three ways:

First, tax increase proposals should be structured to interfere as little as possible with the incentives enacted last year to expand savings and investment and to increase productivity. As you well know, the Economic Recovery Tax Act of 1981 established for the first time an R. & D. tax credit effective through 1985. The enactment of the credit constituted a major breakthrough in U.S. tax policy. Increases in research can improve the productivity of our

companies and help us maintain the technology necessary to compete in the world markets.

It is our understanding that this committee may consider some limitation on the credit this year. We would urge you in the strongest terms to defer any such consideration. The revenue cost of the credit is not large. Moreover, for that cost the credit can yield substantial improvements in productivity and in the competitiveness of U.S. companies. We expect that in 1984 and 1985 Congress will undertake a thorough reexamination of the credit and determine its effectiveness. However, we submit that no such review should be taken until that time.

Second, any tax increase proposals affecting the foreign operations of U.S. companies must take into account the fact of international competition and its impact on U.S. economy. U.S. electronics companies must be competitive in worldwide markets in order to remain competitive in U.S. markets. For this reason most medium and larger sized companies not only export substantial volumes of products, but they also manufacture abroad. U.S. tax policies affect the ability of U.S. companies to compete abroad. Unlike some of our foreign competitors, which are often sheltered from international markets, U.S. companies must make market rates of return after taxes on their foreign operations in order to justify their investments. Any action taken by Congress to increase U.S. taxes on the foreign operations of U.S. companies, even if done solely for the purposes of an alternative corporate minimum tax, will automatically reduce the rate of return of U.S. companies and place them at a significant competitive disadvantage.

Third, we believe that this committee should not pursue issues of tax purity or so-called tax reform for their own sake in this bill. Thus, for example, we urge that this committee not consider any modifications to the incentive stock option provisions enacted last year, even for the purposes of any new minimum tax on individuals. Enactment of incentive stock options last year increased rather than decreased revenues. Any cutback in the benefits of incentive options would make such options less attractive and would tend to lose revenues by increasing the number of nonqualified option plans. Thus we believe that any discussion of restricting the benefits of incentive stock options in this bill is inappropriate.

In conclusion, Mr. Chairman, let me say that we are not here merely to oppose raising taxes. Instead, we believe that, as we just have discussed, the committee must take into account the particular impact of each revenue raising proposal on needed increases in investment, productivity, and on the ability of U.S. companies to compete in the world markets.

I appreciate your kind attention. I would be happy to respond to any questions.

Chairman ROSTENKOWSKI. Thank you, Mr. Berman.

[The prepared statement follows:]

Statement of George M. Berman, Chairman and President, Unitrode Corp., on Behalf of the American Electronics Association

SUMMARY

If additional revenue is to be raised through increased taxes, those increases should be structured to interfere as little as possible with the incentives enacted last year to increase productivity, savings and investment.

Possible tax increases that would be counterproductive to the longterm viability of the U.S. high technology industries include limitations on: The R. & D. tax credit; incentive stock options; industrial development bonds; completed contract accounting; foreign tax credit; cost recovery on short lived equipment; and present methods of estimating corporate tax payments.

STATEMENT

Mr. Chairman and Members of this distinguished Committee: I am George M. Berman, Chairman and President of Unitrode Corporation headquartered in Lexington, Massachusetts. At Unitrode we manufacture electronic components, including power semiconductors, data convertors and multilayer ceramic capacitors. We have plants in New Hampshire, Maine, and California, and employ 2,000 people. We derive 15 percent of our sales revenue from exports and devote 6 percent of it annually t R. & D.

I am appearing before you this morning on behalf of the American Electronics Association. AEA is the largest association of high technology electronics firms in the nation. Our members manufacture semiconductors, components, computers, instruments, defense products, and systems. Many supply products and services in the communications industries.

Like the electronics industry itself, AEA's membership contains many more small firms than large. Of our 1,900 plus members in 43 states, 80 percent employ 500 people or less. These are fast growing entrepreneurial firms with strong free market and free trade views. I have served on the AEA Board of Directors for the past four years.

AEA welcomes this opportunity to come before this Committee to discuss the tax increase proposals of the Administration and others. We are not here to oppose any tax increase under any circumstances. We recognize the danger to economic recovery caused by high interest rates and huge Federal deficits. At the same time we believe that any tax increase proposals should be structured to interfere as little as possible with the incentives enacted last year to expand savings and investment and to increase productivity.

TREATMENT OF RESEARCH AND DEVELOPMENT ACTIVITIES

As you well know, the Economic Recovery Tax Act of 1981 established for the first time an R. & D. tax credit. The credit is applied to increases in R. & D. expenditures for the current year over the average expenditures for the past three years. The credit is being phased-in in 1981 and 1982; it will be fully effective in 1983 through 1985. At the end of 1985 the credit is scheduled to expire. We believe that enactment of the credit constituted a major breakthrough in U.S. tax policy. It signified the Federal Government's interest in encouraging increased private research (including university research). Such increases in research can improve the productivity of U.S. companies and help them maintain the technology necessary to compete in world markets.

The credit was enacted for only a five-year period (including two years for which the credit is being phased in). During this time AEA has already committed itself to working with its member companies to make certain that they understand the available benefits of the credit and that they take into account the impact of the credit on corporate budget and planning decisions. In addition, AEA has already begun to prepare questionnaires to be sent each year to member companies in an attempt to obtain the best possible information on the utilization of the credit and the extent to which the credit has in fact caused increases in research expenditures.

It is our understanding that this Committee might consider some limitation on the credit this year. We would urge you in the strongest of terms to defer any such consideration until the credit has had a chance to work. The revenue cost of the credit is not large by relative standards. Moreover, for that revenue cost the credit could yield substantial improvements in the productivity and the competitiveness of U.S. companies over the next few years. We hope and anticipate that in 1984 or 1985 Congress will undertake a thorough reexamination of the credit and determine

the extent of its beneficial effects. However, we submit that no such review should be undertaken prior to that time.

Instead, the Committee should focus its attention with respect to the R. & D. credit on measures to help implement its purposes. Through a tax working group, AEA is currently developing a list of technical questions and problems with respect to the credit which we would like to discuss with you at another date. Further, through its Blue Ribbon Committee on Engineering Education, AEA is reviewing the possibilities for expanding the credit (and related provisions for contributions of equipment) with respect to university research. We recognize that today's hearing is limited to other questions, and, thus this is not the time to bring these proposals before this Committee. However, we do believe that this Committee should address these proposals in the near future and that, in the meantime, no actions should be taken to undercut the implementation of the R. & D. credit.

STOCK OPTIONS

It is our understanding that the Committee is considering some cutback in the treatment of incentive stock options, perhaps in the form of subjecting the bargain element of such options to any alternative minimum tax to be applied to individuals. We would strongly oppose such legislation. Enactment of incentive stock options last year was a revenue-raising, not a revenue-losing, provision; the corporate deduction for any bargain element in the options, when exercised, which is lost if the options qualify as incentive stock options, more than outweighs the tax benefit from the exclusion of that bargain element from the income of individual recipients.

Over ten years ago qualified stock options, the predecessors of today's incentive stock options, were subjected to the broad-based add-on minimum tax. That change greatly limited the attractiveness of qualified stock options to employees, since the minimum tax was often imposed at a time prior to the date on which the individual would sell the stock. Thus, the tax was due even though the individuals had no cash from the stock with which to pay the tax. As a result, companies and employees switched increasingly over time from qualifed to nonqualified stock option plans.

If now the bargain element of incentive stock options is subjected to an alternative minimum corporate tax in the hands of individual employees, incentive stock options, like qualified stock options, could fall into disuse. Imposing a tax on the individual recipients without any comparable deduction permitted to corporations could make incentive stock option plans relatively unattractive. Thus, conceivably the Federal Government could end up picking up little revenue through the minimum tax preference and at the same time losing significant revenue because companies would respond by switching from incentive stock options to nonqualified option plans.

We believe that this Committee should not pursue issues of tax reform or tax purity for their own sake in this bill. Rather, as stated above, the Committee's purpose should be to raise revenues while doing minimal damage to the incentives enacted last year. On this basis we urge that this Committee not consider any modifications to the incentive stock options provisions.

ADMINISTRATION'S TAX PROPOSALS

Corporate minimum tax and DISC.—The Administration has proposed a new alternative corporate minimum tax which would be computed without credits (other than the foreign tax credit) on corporate taxable income plus certain so-called "preference items." We do not argue that any such corporate minimum tax should be rejected out of hand. However, we do believe that the Administration's proposal includes certain features that make it unwise policy.

First, deferred DISC earnings are to be treated as a preference for minimum tax purposes. As you well know, DISC was enacted in 1971 as an incentive for expanded exports. AEA member companies in the aggregate export a significant portion of total U.S. manufacturing exports. DISC has been a major factor in helping electronics companies generally to expand into world markets. Subjecting DISC income to a corporate minimum tax would significantly erode the incentives provided by DISC.

Moreover, once companies begin to sell exports through a DISC, it is extremely difficult for them to discontinue doing so. Indeed, if they do stop exporting through their DISCs, they run the risk of forcing a recapture of all prior year DISC benefits. Such a recapture could have a devastating impact on many companies. Thus, the effect of limiting DISC benefits through a corporate minimum tax or otherwise could be not only to reduce or eliminate future DISC benefits but also to jeopardize the tax treatment of benefits from prior years.

Industrial development bonds.—The Administration has proposed a number of limitations on the use of small issue and other industrial development bonds. The ability to obtain industrial development bond financing for new facilities has been a major factor in assisting small electronics companies to increase their capacity. We recognize that the present industrial development bond rules may have led to some abuses. However, those abuses can be eliminated without limiting the positive uses of industrial development bonds for many small businesses, including high technology companies. For example, the use of such bonds under existing rules could be limited to new manufacturing and assembly facilities (and not, e.g., retail stores) owned by relatively small companies. We urge that the Committee focus its considerations on restricting specific abuses which may have arisen and not adopt an overall reduction in the usefulness of industrial development bond financing for small companies.

In addition, one aspect of the Administration's proposals relating to industrial development bonds is directly discriminatory against high technology companies. The Administration proposes that any equipment financed through industrial development bonds not be eligible for ACRS but instead be written off on a straight-line basis over eight years. Presumably the intent of this proposal is to eliminate any benefits from ACRS for taxpayers financing equipment with industrial development bonds. While this policy goal may be unobjectionable, the assumption that all equipment should be written off over the same eight-year period of time is patently incorrect. Since the equipment of most high technology companies has actual useful lives of three or four years, anything which reduces the five-year ACRS depreciation deductions by requiring depreciation over a longer than five-year period does more than merely eliminate an incentive with respect to short-lived equipment. It creates a substantial penalty for that equipment, which penalty does not apply to longer-lived equipment.

Estimated corporate tax payments.—The Administration also proposes a speeding up of estimated corporate tax payments for all corporations. Further, the Administration proposes phasing out the provision under which a company is permitted to base its current year estimated tax payments on its immediately prior year actual tax liability. In industries as volatile and uncertain as those in which electronics companies compete, it is very difficult to accurately estimate tax liability for a particular year until substantially after the end of that year. Indeed, at the time of each quarterly estimated tax payment, most companies do not have firm tax data on which to make estimates even on a quarterly or year-to-date basis. Thus, for many companies the process of determining proper estimated payments is largely guesswork.

To the extent that quarterly estimated payments are too low, however, the Service can impose a nondeductible penalty in excess of 20 percent. To avoid this penalty under the Administration's proposal corporations will be forced to estimate their taxes at very high levels. Yet, if the taxpayer later determines that it overestimated the amount of its tax liability, the taxpayer receives no interest on any refund of overpaid tax.

Thus, under the Administration's proposal the Government has it both ways: the Government collects a large and nondeductible penalty on underpaid taxes and pays no interest or other comparable amount on overpaid taxes. Given this bias in the system we recommend that corporate tax payments not be accelerated any more than was done in 1980. If some additional speed-up is to be enacted, at the very least some symmetry in the treatment of under and overpayments ought also to be introduced (e.g., through permitting interest to be paid at market rates on overpayments) so that taxpayers which on a conservative basis overpay their taxes would not be penalized for having speeded-up the Federal collection process.

COMPLETED CONTRACT METHOD OF ACCOUNTING

The change in accounting for long-term contracts proposed by the Administration would reverse 60 years of well-founded tax policy while having the net effect of "window-dressing" by merely speeding up tax collections. The withdrawal of the deferral of taxes until contract completion would cause many companies to borrow substantial sums in order to finance work on long-term contracts, thereby aggravating the interest rate and credit availability problem.

It has been popularly assumed that this change would affect only major defense contractors. Our research indicates, however, that many companies selling commercially under long-term contract would also be adversely affected. We recommend that your consideration of this area be limited to specific abuses and not involve broad policy changes.

EXPANSION OF CORPORATE MINIMUM TAX

It is our understanding that this Committee and the Senate Finance Committee are considering various alternatives for expanding the Administration's corporate minimum tax proposal. While we do not wish to discuss each of the proposed expansions in that proposal, we do believe that various possible methods of expanding the tax with respect to international operations should be discussed in some detail.

U.S. electronics companies generally must be competitive in worldwide markets in order to remain competitive in U.S. markets. For this reason, most medium and larger-sized companies not only export substantial volumes of products, as was discussed above, but they also manufacture abroad. It is thus important that the members of this Committee understand the particular significance of corporate minimum tax proposals as they affect companies with international operations.

One cannot dispute the fact that U.S. tax policies can affect the ability of U.S. companies to compete abroad. Most foreign competitors of U.S. companies are either exempt from tax in their home country on their earnings from outside that country or their home country has established a foreign tax credit mechansim to avoid any double taxation of worldwide corporate earnings. The allowance of a full tax credit in the United States for foreign taxes paid on income from international operations permits U.S. companies to compete abroad on an equal or near-equal basis with foreign companies. Unlike some of their foreign competitors, which are somewhat sheltered from international markets, U.S. companies must make after-tax market rates of return from their foreign operations in order to justify their investments. Any actions taken by Congress to adjust or eliminate the foreign tax credit mechanism—even if done solely for purposes of an alternative corporate minimum tax—automatically reduces the rate of return of all U.S. companies paying the tax and thus inevitably places these companies at a significant competitive disadvantage in world markets.

In addition, any cutback in the tax treatment of companies with operations in Puerto Rico and the possessions can have a negative effect on the economies of those jurisdictions. Most qualified investments in Puerto Rico by high technology companies could have been made elsewhere, including in other Caribbean countries. However, the special U.S. tax treatment of possessions corporations makes it significantly more attractive to locate in Puerto Rico. Any cutback in the benefits offered to companies investing in Puerto Rico—including a provision to make income earned in Puerto Rico subject to an alternative minimum tax—would not raise significant revenue because the companies would tend to locate their operations in foreign countries and would be counterproductive to U.S. efforts to assist Puerto Rico and the possessions.

SHORT-LIVED EQUIPMENT

If this Committee is to consider an expanded corporate minimum tax or if the Committee reexamines the basis ACRS system enacted last year, the circumstances of companies, like AEA members, whose equipment is generally depreciated over three or four years for financial purposes must be taken into account. The equipment of many AEA members has short lives because technology is moving at a sufficiently rapid pace that equipment becomes obsolete every three to four years. Under ACRS that equipment is predominately included in the class of property to be written off over five years. Thus, under ACRS depreciation deductions for high technology equipment generally are smaller than is required to reflect economic reality. However, under ACRS the availability of a full 10 percent investment tax credit for this equipment tends to offset the inadequate depreciation. Yet, in a context where no investment credit is available, for example under the President's alternative minimum tax proposal, electronics companies must be permitted at least to depreciate equipment over a period of time that reflects their actual economic lives.

Alternatively, five-year depreciation would not be too unrealistic if the methods under which such depreciation can be taken are similar to that permitted under the law prior to the 1981 Act (i.e., double-declining balance method). In this way the companies with short-lived assets, which obtain no benefit from ACRS apart from the investment credit, would not be injured by any actions of this Committee to reduce the benefits of the ACRS system for taxpayers generally.

CONCLUSION

Mr. Chairman, as I said at the outset, we are not here to oppose raising taxes generally or even to oppose raising the taxes of AEA members. Instead, we believe

that, in considering tax increase proposals, the Committee must take into account the partiular impact of those specified proposals on necessary business incentives. The Committee must keep in mind that any actions to raise substantial revenues by increasing taxes on the international operations of U.S. multinational corporations will likely do more to harm those corporations' ability to compete abroad than such actions will assist in increasing Federal Government revenue. Similarly, cutbacks in the present tax incentives associated with research and development expenditures before those incentives have had a chance to become fuily effective might raise some revenue but could also in the long run be detrimental to the U.S. economy by making it more difficult for U.S. companies to undertake necessary R&D efforts. Finally, any changes to tighten up the rules for incentive stock options are likely to decrease, not increase, revenues while at the same time reduce the incentives inherent in those provisions.

I appreciate your kind attention and will be happy to respond to any questions you may have.

Chairman ROSTENKOWSKI. Mr. Cherecwich, you may proceed.

STATEMENT OF PAUL CHERECWICH, JR., CORPORATE TAX MANAGER, FOXBORO CO., AND CHAIRMAN, TAX COMMITTEE, SCIENTIFIC APPARATUS MAKERS ASSOCIATION

Mr. CHERECWICH. Good morning. I am Paul Cherecwich, Jr., the tax manager for the Foxboro Co. in Foxboro, Mass.

We are manufacturers of industrial process control instrumentation. In 1981 my firm had sales of $607 million, approximately 50 percent of which took place outside the United States. We expended $37 million in R. & D. expense.

I am appearing before you today in my capacity as chairman of the Tax Committee for the Scientific Apparatus Makers Association. We are a group of 180 member companies active in the manufacture of scientific instrumentation. In 1980 our member companies expended 5.6 percent of sales on R. & D. which represented 87 percent of their after-tax profits and over 150 percent of their capital expenditures.

Sales in this industry were approximately $12 billion. Exports were approximately 33 percent.

I believe there is a direct correlation between the ability to compete in the export markets and the very high level of R. & D. expenditures.

We understand that the Congress is now confronted with a revenue/expenditure dilemma. While we are not opposed to tax increases per se, we do hope that in attempting to solve one problem another series of problems is not created.

I would like to specifically address my comments to the administration's tax proposals in the area of completed contract accounting, the corporate minimum tax and tax-exempt revenue bonds.

In the area of completed contract accounting, one brings to mind defense contractors and other large construction firms such as were described in last Saturday's Washington Post.

In point of fact, many taxpayers use the accrual shipment inventory method and the administration's regulatory proposals would add an excessive accounting burden for those taxpayers now on the accrual shipments inventory method.

For example, selling costs would have to be allocated to inventory in connection with successfully obtained orders.

Many small companies who have sales offices scattered throughout the United States do not keep selling costs on the basis of whether or not orders were successfully obtained.

My written testimony has numerous other examples.

The administration's legislative proposals in the completed contract area will create a serious burden on our industry's ability to obtain financing from its customers. Even though we do not use completed contract accounting methods, we do use down payments and progress payments as a means of obtaining working capital.

The administration's proposals would tax us when that money was received rather than when we shipped the goods.

I believe that the administration was not aware of the sweeping nature of their proposals for those taxpayers who are just using inventory methods of accounting.

In the area of the corporate minimum tax, we have two specific objections. First, the treatment of DISC income as a preference item. The DISC has proven extremely beneficial as an incentive for this country's exports since this legislation was passed in 1972.

We believe that this export incentive should be encouraged. To include deferred DISC income as a preference item would be to play right into the hands of our trading partners in France, Belgium, and the Netherlands, who recently lost the debate with the United States in Geneva under the GATT.

We also are not pleased to see that R. & D. credits would not be allowed against the corporate minimum tax. After the passage of ERTA, SAMA surveyed its members and we determined that 86 percent of our members plan to increase their R. & D. expenses as a result of the new R. & D. tax credit.

Increasing R. & D. results in a decrease in profits. A decrease in profits would bring in the administration's proposed minimum tax. But then we would not be allowed to use the R. & D. credit against that tax which defeats the purpose of the incentive in the first instance.

In the area of industrial revenue bonds, SAMA member companies have been frequent users. The administration seems to believe that the use of small issue industrial revenue bonds is detrimental to our country's economy.

We do not believe that is so.

The administration also seems to believe that ACRS is going to solve all problems. That law will not solve problems for the high technology industries which is why we were so pleased to see the Congress address the problems of the high technology industries by passing the R. & D. credit.

If anything, we believe that the Congress should increase the usefulness of industrial revenue bonds by removing R. & D. expenditures from the $10 million capital limitation.

This was recently proposed by Mr. Shannon in H.R. 4444.

Rather than penalize high technology firms, we hope the Congress will consider issues on which action was postponed under ERTA.

Because of certainties required in business planning we hope the 4-year termination of the R. & D. tax credit will be eliminated and that the 2-year suspension of regulation 1.861-8 will be made permanent.

This will be accomplished in legislation introduced by Mr. Stark under H.R. 5332.

Third, we hope that the university basic research expenditures will be removed from the R. & D. credit base period.

And, last, we would suggest that it would be appropriate to allow a fair market value deduction for depreciated assets given to universities for use in R. & D.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Cherecwich.

[The prepared statement follows:]

STATEMENT OF PAUL CHERECWICH, JR., THE FOXBORO CO., ON BEHALF OF THE SCIENTIFIC APPARATUS MAKERS ASSOCIATION

SUMMARY OF RECOMMENDATIONS

SAMA believes that the Administration's proposed tax revisions and improved collection and enforcement proposals would have a fundamentally negative impact upon our high technology industries in at least three areas: Completed contract accounting; tax exempt revenue bonds; and corporate minimum tax.

The regulatory language in the completed contract accounting regulations would impose a significant accounting burden on high technology companies using the accrual shipments method of accounting, in return for very little additional revenue. These proposals should not be put into effect.

The proposed completed contract accounting legislation would remove a very significant source of financing for high technology companies (i.e., advance payments from customers). The accrual shipment of accounting should be allowed to stand for high technology companies.

The Congress should encourage the use of tax exempt revenue bonds by removing the R. & D. expenditures from the limitation of capital expenditures presently found in the law.

The Administration's proposals on the corporate minimum tax are defective in several areas. The most flagrant deficiency is the attempt to include deferred DISC income as a preference item. Also, to deny the use of the R. & D. credit against the corporate minimum tax would be to penalize those very corporations for whom last year's R. & D. tax credits were intended to be a major incentive in connection with our country's need to maintain its technological edge.

Congress should give early consideration to those R. & D. issues postponed under ERTA and: Eliminate the four year termination for R. & D. tax credits; Remove Section 44F(e) university research expenditures from the R. & D. credit base period; Make permanent the suspension of Regulation 1.861-8 as it applies to R. & D. expenses; and Add an additional charitable deduction under Section 179(e)(4) for the fair market value of depreciated assets donated for use in university R. & D.

STATEMENT

Mr. Chairman and Members of the Committee: My name is Paul Cherecwich, Jr. and I am the Corporate Tax Manager for The Foxboro Company, which is headquartered in Foxboro, Massachusetts. In 1981, my company had a total sales volume of $607 million. Of this amount, approximately 50 percent represented products sold outside the United States.

I am appearing before you today on the behalf of the Scientific Apparatus Makers Association (SAMA), for which I serve as Chairman of the Tax Committee.

SAMA is a national trade association representing this country's manufacturers and distributors of a wide range of scientific, industrial and medical instruments and equipment. The 180 companies who are SAMA members, many of small or moderate size, constitute the bulk of American industry producing research, laboratory, analytical, electronic test and measurement, and process measurement and control instruments, as well as clinical laboratory instruments, patient monitoring instruments, and a wide range of laboratory apparatus and equipment.

In 1979, SAMA member companies expended an average 5.6 percent of their sales on research and development activity. This number represented 86.9 percent of after tax profits, and 150.9 percent of capital expenditures. SAMA companies are clearly R. & D. oriented and R. & D. dependent.

In 1980, the industries represented by SAMA produced and shipped products valued at over $12 billion. Exports accounted for about one-third of total sales, although for some SAMA companies, exports may amount to 50 percent or more of total sales. Since over a third of our industries' total sales are related to exports of U.S. products, it is obvious that a substantial number of the jobs of more than one-quarter of a million U.S. workers employed by our industries are directly dependent upon international trade, and the competitiveness of the United States in world markets. It should also come as no surprise that those businesses which have expended funds on R. & D. in the past have been successful in the international marketplace.

I am appearing before you today to comment upon the tax revisions and improved collection and enforcement proposals announced in the President's State of the Union Address on January 26, 1982, and as explained in the Department of Treasury Release dated February 26, 1982.

At the outset, let me say that I understand and I am sympathetic with the need for Congress and the Administration to address the realities of the economic situation now being faced by our country. There are many persons much more qualified than I to address the question of how best to raise revenues to achieve a balanced budget. At the same time, I believe that there are certain aspects of the Administration's tax proposals which will have a serious, long-term adverse impact on SAMA members and other high technology companies which may not be fully understood by the Administration or by members of this Committee. Therefore, I will limit my comments to those proposals likely to have small revenue impact to the U.S. Treasury but a large economic impact on the future growth of scientific, industrial, medical and related industries represented by SAMA.

Specifically, we believe that the completed contract accounting proposals, tax exempt revenue bond proposals, and corporate minimum tax proposals will, if enacted as proposed, have an adverse effect upon high technology industries beyond mere revenue impact. Enactment of the proposals is likely to be detrimental to the ability of our industries to compete in the world marketplace in the years ahead.

COMPLETED CONTRACT METHOD OF ACCOUNTING

The Administration has proposed a two-pronged approach to the issue of completed contract accounting. The first approach would amend existing regulations, while the second approach would require new legislation.

In general, taxpayers may account for contracts that extend beyond a single tax year by using one of three methods of accounting. Two such approaches are the completed contract method and the percentage of completion method. These methods commonly bring to mind the construction of buildings, highways, dams and other facilities, and the custom manufacturer of aircraft, ships and heavy industrial machinery. Most high technology firms do not use either of these methods of accounting. Rather, high technology firms use a third method of accounting known as the accrual shipment method for contracts that extend beyond a single tax year. The accrual shipment method of accounting requires that existing inventory regulations be followed, including the application of full absorption costing, with income and the corresponding cost of sales recognized when all goods in a contract have been shipped.

The Administration's regulatory proposals first amend the completed contract costing rules under Regulation 1.451-3(d) and then amend the inventory rules under Regulation 1.471-11 to provide that a taxpayer using an inventory method of accounting for a long term contract must use the same costing rules as taxpayers using the completed contract method. Such rules will be unduly burdensome to the high technology industries unless the regulations recognize the sheer volume of individual contracts likely to be covered.

For example, the technical explanation suggests that general marketing, selling, and advertising expenses will be exempt from the full costing rules, along with bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer. By implication, bidding expenses incurred in the solicitation of contracts awarded to the taxpayer must be included in indirect costs which are allocated to long term contracts. For taxpayers reporting the results of many small contracts on the accrual shipment method of accounting, this would impose an impossible accounting burden. Such taxpayers typically lump all selling expenses into one account, with no attempt made to separate selling expenses into success or failure accounts. A solution to this problem might be to exempt from allocation to long term contracts those bidding expenses incurred in the solicitation of contracts awarded to the tax-

payer where the taxpayer normally treats such expenses as general selling expenses (period expenses) for purposes of financial reporting.

We also note that the Administration proposes to amend Regulation 1.451-3(d) to require the allocation to long term contracts an appropriate part of indirect costs not directly benefiting long term contracts. A comparison of the exceptions proposed by the Administration to this rule with the exceptions currently listed in the regulations leads to the conclusion that the Administration wishes to abolish the deductibility of period costs. In addition to creating a tax system under which revenues and expenses are no longer matched, such an approach would impose large new accounting burdens on high technology firms, along with a corresponding increase in audit problems for both the taxpayer and the IRS.

The Administration also proposes that taxpayers using an accrual method of accounting for multi-unit contracts must account for sales of the various items when each item is delivered or shipped, or when title to individual items passes to the customer. Large orders for SAMA companies are typically comprised of many individual items. As a matter of convenience to both the seller and the buyer, it is common practice in our industries to ship instruments or other equipment as soon as manufacturing has been completed. For insurance purposes, title to the individual items normally passes to the customer upon shipment. Amendments to Regulation 1.461-1(c) would impose an enormous accounting burden on small high technology companies if large contracts had to be accounted for in many bits and pieces.

The Administration additionally proposes to amend Regulation 1.451-3, so that contracts will be considered complete without regard to any obligation on the part of the selling company to supervise installation of the subject matter of the contract. SAMA believes this provision is arbitrary, and one which flies in the face of reality. If a customer who has purchased industrial instrumentation does not consider a contract complete until he has installed the instrumentation and verified that it is functioning properly, why should a taxpayer be forced to assume for income tax purposes that its contract is complete?

Although the regulatory proposals, if put into effect, would cause additional accounting problems for many high technology companies, the Administration's proposal for a new Code Section 451(f) entitled "Special Rule for Accounting for Long Term Contracts" would cause significant fundamental problems. In attempting to correct a perceived problem in selected industries (construction of buildings, highways, etc., and custom manufacturing of aircraft, ships, etc.), the proposed legislation would directly and negatively affect SAMA companies. Under the Administration's proposal, taxpayers must use either the progress payment method of accounting or the percentage of completion method. Under the progress payment method, the Treasury explanation appears such that any payments received from any source would be considered progress payments. Because of a great need for capital to finance research and development activities, many SAMA firms have turned to their customers for assistance in financing production contracts. Thus, advance payments are obtained from customers for use as working capital.

Under the Administration's legislative proposal, taxpayers would not be allowed to use the accrual shipments method of accounting presently allowed under the inventory regulations, but rather would be forced to report the financing payments received from customers as income at the time of receipt. Such a provision would defeat the basic purpose for which advance payments are solicited from customers, and would have a profoundly adverse impact upon the ability of our industries to maintain their existing levels of R. & D. expenditures.

In all candor, it appears that the Administration is unaware of the sweeping nature of its proposals in the completed contract accounting area. The regulatory proposals would impose an extra accounting burden on many high technology companies without a particularly large speed-up in tax payments. The legislative proposals would have an absolutely devastating effect on one of the methods used by SAMA companies to raise capital, (i.e., advance payments from customers), and would no longer provide the cash flow previously available. This, in turn, would seriously curtail our industries' R. & D. efforts.

TAX EXEMPT REVENUE BONDS

The Administration has noted that the volume of tax exempt bonds issued for non-government users has grown rapidly during the past five years, with the largest increase occurring in small issue bonds. SAMA and other high technology companies have been a large user of small issue industrial development bonds. The Administration appears to believe (at least as inferred from the Treasury explanation) that it has been detrimental to our country's interests to help high technology firms

find necessary capital, in spite of the fact that it is these very firms which have helped to provide so many of the new products, exports and jobs necessary for our country's economic health. The Administration apparently also believes that in combination with the Accelerated Cost Recovery System (ACRS), tax exempt financing can result in a substantial negative tax or subsidy for qualifying activities.

We believe it is important to emphasize that the ACRS enacted last year was not a panacea to high technology companies. In fact, although SAMA supported ACRS in 1981, our members and other high technology firms did not benefit directly from its provisions, since many of these firms were already using accelerated methods of depreciation over shorter asset lives than currently allowed by ACRS. This was one of the reasons why we were especially grateful when the Congress and Administration decided to address the unique problems of high technology companies head-on, and enacted credits for research and development expenditures.

High technology companies, and in particular SAMA firms, require every bit of help they can get to raise capital in order to maintain their high level of R. & D. expenditures and, thus, their competitive position in the world marketplace, and the continuation of the growth of their export capabilities. Rather than limit the usefulness of industrial development bonds for high technology companies now, SAMA believes Congress should, in the near future, consider increasing their usefulness by removing R. & D. expenditures from the capital expenditures limitation presently found in the statute.

NEW CORPORATE MINIMUM TAX

The Administration has determined that many corporations presently pay little or no federal corporation income tax, despite reporting large profits to their shareholders. In order to correct this problem, the Administration proposes to create an expanded list of items of tax preference subject to a new alternative minimum tax, and to limit the amount of credits which could be taken against such a tax.

As stated earlier, high technology companies require a sustained cash flow in order to maintain and improve their existing level of R. & D. expenditures, which will, in turn, help maintain their competitiveness in world marketplaces. R. & D. cannot be financed with mortgages or other long-term financing vehicles; R. & D. must be paid for currently out of cash flow. Thus, the addition of any item of so called tax preference or the denial of any tax credits which affect high technology industries will affect cash flow, and have a direct impact on their ability to continue to finance R. & D.

The Administration proposes that accelerated depreciation on real property should be considered an item of tax preference. We believe the Congress has already written into the law sufficient safeguards against abuse from accelerated depreciation on real property, by requiring that any gain from the sale of property which has been depreciated using accelerated depreciation be considered as ordinary income rather than capital gains income. Thus, it is our view that this item of tax preference is not required.

Deferred Domestic International Sales Corporation (DISC) income would also be considered an item of tax preference under the Administration's proposal. This item would have a very serious impact on high technology companies, which have been taking the lead in U.S. exports. DISC has been extremely valuable as an export incentive to SAMA companies and other high technology exporters; so valuable, in fact, that some of our trading partners have complained to the Secretariat for the General Agreement on Tariffs and Trade (GATT), and have attempted to have this incentive eliminated. The Administration has just concluded a successful fight in Geneva to enable the United States to maintain DISC under the GATT rules. To now turn around and make deferred DISC income an item of tax preference for the corporate minimum tax would defeat the very reason for the DISC in the first place, and impose its major burden on those high technology companies which have been most successful in pursuing an important national goal; i.e., increasing U.S. exports. We do not believe that treating deferred DISC income as a tax preference would further the government's objective to increase exports; it would, in fact, have just the opposite result.

The Administration has taken the position that no credits other than foreign tax credits should be allowed to offset the new minimum tax. Under these circumstances, SAMA is particularly concerned about the continued usefulness of the R. & D. credit recently enacted into law.

To put this concern into perspective, SAMA conducted a survey of its membership following the enactment of the Economic Recovery Act of 1981 (ERTA). Results of this survey show that ERTA will cause 86 percent of responding SAMA companies

to increase their R. & D. activities, with over one-half the companies expecting an increase in 1982 beyond what they had originally planned to spend in the R. & D. area. Thus we foresee that ERTA will have its desired impact in our industries.

Ours are among the very industries which have been characterized by current low profitability as a result of their heavy current R. & D. expenditures. Last year, we received what we view as a major encouragement under ERTA to continue R. & D. expenditures, in spite of the impact on current profitability. Yet the Administration now proposes to take that incentive away with a corporate minimum tax against which the R. & D. credit will not be allowed. This will serve to defeat the very purpose for which the R. & D. credit was enacted, i.e., to help the high technology low or no profit company find the capital resources necessary to continue high levels of R. & D. expenditures.

The adverse impact of the Administration's minimum tax proposals on high technology companies may be unintended. We hope so. Rather than penalizing high technology companies, we hope the Congress will consider in the near future the following issues on which action was postponed under ERTA.

(1) ERTA established a twenty-five percent tax credit for certain research and experimental expenditures to the extent that current year expenditures exceed the average amount of such expenditures during a base period. This provision will expire on December 31, 1985. While SAMA applauds last year's action to stimulate R. & D., we are concerned over its temporary nature. In our view, there can be no more important national objective than restoring our commitment to increase levels of R. & D. activity. As noted by several members of this Committee, our levels of research and development expenditures have fallen way behind those of Japan and West Germany, and as a result, we are losing world markets and U.S. jobs to foreign competition. A firm commitment to expanding research and development efforts is needed, and we hope that the Congress will make such a commitment by eliminating the termination provision of ERTA for the R. & D. tax credits.

(2) ERTA suspended for a two year period regulation 1.861-8 as it applied to the allocation of domestic R. & D. expense to foreign source income. As explained earlier, high technology companies have been in the forefront of U.S. export activity. Such companies are often required to establish sales and service operations abroad in order to expand and support their exports. Such operations are naturally taxable by the host government. Normally such taxes are creditable in the U.S., but where a foreign operation makes use of technology from the U.S. in order to further U.S. exports, Regulation 1.861-8 would operate to deny tax creditability. The two year suspension should be made permanent.

We note that both recommendations 1 and 2 are addressed in H.R. 5332, a bill introduced by Mr. Stark. SAMA is in full support of this legislation.

(3) ERTA, as enacted, provided an R. & D. credit for expenditures in excess of base period expenditures. Qualified research expenditures include amounts paid for basic research by colleges and universities. Legislation approved by this Committee last year exempted such expenditures from the base period calculations on the grounds that a revitalization of university/industry cooperation in basic research was needed, and all possible incentives should be given to accomplish this objective. That concept is still valid, perhaps more so today than a year ago, and SAMA believes Congress should remove the requirement to include Section 44F(e) expenditures in the base period computations.

(4) ERTA also provided a special deduction for charitable contributions of scientific property used for research by colleges and universities. However, new Code Section 179(e)(4) is limited to contributions of inventory. We believe our country's technological health would benefit if industry were also encouraged to donate depreciated production and laboratory assets, along with inventory. Thus, Congress should expand Section 179(e)(4) to allow a deduction for the fair market value of Section 1231 assets donated to colleges and universities for use in research.

We believe these issues will have minor revenue impact in the short run, but very favorable overall economic impact in the future, and we hope that serious consideration will be given to each of these proposals later this year.

CONCLUSION

In conclusion, Mr. Chairman, SAMA understands the revenue/expenditures dilemma now being faced by the Congress and the Administration, and we are sympathetic with efforts underway to resolve the dilemma. We do not necessarily oppose proposals which will increase our companies' tax liability. We do hope, however, that in attempting to solve one problem, another series of problems is not created. Specifically, SAMA believes that the Administration's proposed tax revisions and

improved collection and enforcement proposals, if unaltered, will have a fundamentally negative impact upon our high technology industries in at least three areas: (1) Completed contract accounting; (2) tax exempt revenue bonds; and (3) corporate minimum tax.

With regard to the regulatory proposals in the completed contract accounting area, the Administration would impose a significant accounting burden on high technology companies using the accrual shipments method of accounting, in return for only a change in the timing of revenue collection. These proposals should not be put into effect.

With respect to the completed contract accounting legislation proposals, the Administration would remove a very significant source of financing for SAMA members, i.e., advance payments from customers. The accrual shipment method of accounting should be allowed to stand for high technology companies.

The Administration's proposal with respect to tax exempt revenue bonds is based in part on the assumption that high technology companies have benefited from ACRS, whereas in many cases the reverse is true. Rather than attempting to limit the use of industrial development bonds, the Administration should encourage their use by removing R. & D. expenditures from the limitation of capital expenditures presently found in the law.

Finally, the Administration's proposals on the corporate minimum tax are we believe, defective in several areas. The most flagrant deficiency, in our view, is the attempt to include deferred DISC income as a preference item, when to do so would be to offer our foreign competitors exactly what they have been looking for in the GATT for several years. Also, to deny the use of the R. & D. credit against the corproate minimum tax would be to penalize those very corporations for whom the R. & D. tax was intended to be a major incentive in connection with our country's need to maintain its technological edge.

SAMA believes that instead of attempting to penalize high technology companies before ERTA has had a chance to work, Congress should give early consideration to those R. & D. issues postponed under ERTA and: (1) Eliminate the four year termination for R. & D. tax credits; (2) remove Section 44F(e) university research expenditures from the R. & D. credit base period; (3) make permanent the suspension of Regulation 1.861-8 as it applies to R. & D. expenses; and (4) add an additional charitable deduction under Section 179(e)(4) for the fair market value of depreciated assets donated for use in university R. & D.

Mr. Chairman, SAMA thanks you for the opportunity to present these views.

Chairman ROSTENKOWSKI. Mr. Black, you may proceed.

STATEMENT OF ALBERT E. MAY, EXECUTIVE VICE PRESIDENT, COUNCIL OF AMERICAN-FLAG SHIP OPERATORS, AS PRESENTED BY SAMUEL H. BLACK

Mr. BLACK. Mr. Chairman, my name is Samuel H. Black of the law firm of Bowman Conner Touhey and Thornton, representing the Council of American-Flag Ship Operators.

Mr. May, executive vice president of the council, had to excuse himself for a moment and with the committee's permission, until he returns, I would like to read his statement for you.

CASO represents the majority of the international common carriers in the U.S. merchant fleet. Our member companies own and operate a modern, diversified fleet of 161 liner ships, including breakbulk, barge carrier, container, and roll-on/roll-off, vessels. All of these ships are available for use by the U.S. Government during times of military emergency.

I appreciate the opportunity to appear here to present CASO's views on the Treasury's minimum tax proposals as announced February 26, 1983.

We are adamantly opposed to Treasury's minimum tax proposal because it includes a 15-percent tax on deposits by U.S. ship operators into federally administered capital construction funds [CCF]

which are committed to future construction of U.S.-flag merchant ships.

This proposal, if enacted, would destroy the CCF program and would cut deeply into the ability of the U.S. shipping industry to modernize. The proposal should be dropped.

A capital construction fund is set up under a contract between a ship operating company and the Maritime Administration. These contracts, which are authorized by Federal law, require that the taxpayer adopt specific plans for vessel debt payment, vessel reconstruction, or vessel replacement. The cost of these plans for future investment in vessel capacity must be funded by annual contribution from the operator. Contributions in excess of those necessary to carry out the taxpayer's vessel acquisition program are in general, not permitted. Contributions are required even if an operator has a series of loss years.

The CCF program is a necessary response to the fact that our foreign-flag competition pays virtually no tax or is able to save and reinvest earnings in new vessels free of tax. CCF provides a measure of tax parity for the U.S. merchant fleet similar to the tax environment in which our competition operates.

The U.S. merchant fleet faces vigorous foreign competition. Seven foreign-flag fleets are larger than that of the United States. These fleets are fully able to take advantage of low foreign wages and low foreign construction costs, are eligible for the scores of government subsidy programs in place in all foreign nations with fleets of any size, and operate in a virtually tax-free environment.

The other part of our competition is foreign-flag ships owned by U.S. companies. If this were a separate national fleet, it would be the second largest fleet in the world. These ships are able to take advantage of low foreign construction and operating costs and are able to save and reinvest earnings tax free.

By contrast, the U.S.-flag fleet must pay shipbuilding and operating costs which are among the highest in the world.

In order to insure the strength of the U.S. merchant fleet, Congress and the executive branch have, for many years, acted to keep U.S. shipbuilding and operating costs balanced with foreign shipbuilding and operating costs. Specifically, Congress has, since 1936, provided a construction differential subsidy [CDS] which makes payments to U.S. shipyards so they can deliver ships at prices comparable to those charged by foreign yards, and an operating differential subsidy [ODS], which makes labor cost differential payment to operators of U.S. ships so they can employ U.S. citizen seamen and still offer shipping rates comparable to those offered by foreign operators.

In 1970, in a major victory for the U.S. merchant fleet, Congress allowed operators of all U.S.-flag ships in the international trades to defer taxes on earnings placed into capital construction funds for reinvestment in future U.S.-flag ship construction. The CCF program is the key element in putting U.S. ships on a tax footing nearly equal to that of foreign ships and of U.S.-owned foreign-flag ships.

Why do we need a U.S.-flag merchant marine at all? The answer is based in national defense considerations. There has long been agreement, fully backed by the Secretaries of Defense and the

Joint Chiefs of Staff, that the availability of a U.S.-flag merchant marine is of critical importance to the U.S. logistical capability to support its national defense policy.

The cost effectiveness of existing programs for providing sealift support to the military was succinctly stated last year by Rear Adm. Bruce Kenner, then the commander of the Military Sealift Command, U.S. Navy:

> The U.S. Navy, per se, does not have and never will have organic sealift assets sufficient to meet the demands of more than the very first phases of any emergency. The cost in dollars and manpower for DOD to provide that capability would simply be too great. We rely on the U.S. merchant marine for emergency sealift services and sealift assets, both in peacetime and wartime.

Since 1970, CCF's have attracted $2 billion in deposits for modernization and expansion of the U.S. fleet. Disbursements from CCF's have provided or are providing full or partial financing for $5.2 billion in new vessel construction in U.S. shipyards.

In the face of this proven performance, Treasury's proposal represents bad tax policy, bad timing, and bad economics.

Bad tax policy because to tax CCF would mean that the tax law would treat a U.S. taxpayer's investment in foreign-flag ships more favorably than an investment in U.S.-flag ships—a bias which CCF was intended to reduce in the first place; and because to tax CCF would repeal the current approximate U.S. tax parity with the foreign taxes imposed on foreign fleets.

Bad timing, because Congress has repeatedly called for, and the executive branch has promised to deliver, a comprehensive policy for the modernization of the U.S. merchant marine which should involve an expansion of the CCF program.

Bad economics, because the tax on CCF would be a bookkeeper's bandaid on a budget hemorrhage. The tax on CCF would raise less than 1 percent of minimum tax revenues, but would have the effect of repealing the CCF program. Once U.S. tax parity is lost, there would be no incentive to invest in U.S. vessels for the international trades.

We conclude, therefore, that Congress should reject Treasury's CCF proposal.

Mr. Chairman, that concludes my remarks. I request that our more detailed written statement be inserted in the record at this point.

[The statement follows:]

STATEMENT OF THE COUNCIL OF AMERICAN-FLAG SHIP OPERATORS

SUMMARY

This memorandum examines the impact on maritime policy, tax policy and federal budget revenues of the Department of the Treasury's recent proposal to impose a "minimum" tax on deposits into Capital Construction Funds (CCF) established under the Merchant Marine Act. The harmful consequences of this proposal are set out in this memorandum. It is demonstrable that the Treasury proposal will effectively repeal the Maritime Administration's CCF program in order to raise less than 1 percent of minimum tax revenues.

The more important of the harmful consequences of the minimum tax proposal are:

The proposal would re-introduce the U.S. tax bias in favor of U.S. investment in foreign ships, a bias which CCF was designed to reduce.

Treasury's proposal would impose an effective tax rate on shipping twice the rate imposed on other industries.

Even so, the proposal would generate less than 1 percent of minimum tax revenues.

The minimum tax would contradict the terms of thousands of binding CCF contracts with the federal government.

The minimum tax would tax ACRS depreciation and would tax the use of the investment credit; the more capital-intensive the industry, the harsher the minimum tax "bite" would be.

The proposal is completely out of step with the direction of maritime policy being formulated by the Administration as a whole.

The proposal would repeal the established U.S. policy of tax parity for the American fleet as compared to the foreign taxes imposed on foreign fleets.

For these and other reasons, this memorandum concludes that the Treasury proposal should be withdrawn and not enacted.

Analysis of Treasury Proposal To Impose Tax on Capital Construction Funds Established Under the Merchant Marine Act

I. INTRODUCTION

A. Role of the U.S. merchant fleet

For two centuries, American policy toward our international merchant fleet has recognized the major role of the merchant marine in our national security, in diplomacy, and in world trade.[1]

National security concerns have been and are today the predominant factor in shaping federal involvement with the U.S. merchant marine. Every international armed conflict has demonstrated the need for a merchant shipping capability to deploy and supply forces, to import strategic commodities and material, and to maintain a viable domestic economy. Political and military upheavals in the Middle East, the logistical requirements of the U.S. Rapid Deployment Force, and the Falkland Islands crisis are demonstrating these needs today.

Diplomatic and trade concerns have also shaped federal policy toward the maritime industries. Decades of experience have shown the value of a world fleet as visible evidence of the power of a strong nation and have shown the value of the fleet to improve the balance of payments, stabilize freight services and rates and promote exports.

In recent decades, U.S. shipping policy has been a "parity" policy.

This policy has consisted of a ship construction cost parity program, an operating cost parity program, and a tax parity program, administered by the Maritime Administration, known as the Capital Construction Fund ("CCF") program.

On February 26, 1982 the Department of the Treasury announced a proposal to impose a 'minimum tax" on the Capital Construction Fund program. The Council of American-Flag Ship Operators, which represents a majority of the operators of U.S. general cargo liners ships, has prepared this memorandum in opposition to the Treasury minimum tax proposal. This memorandum concludes that the proposed Capital Construction Funds would raise less than 1 percent of minimum tax revenues, at a cost of eliminating tax parity for the U.S. merchant fleet and threatening the destruction of the entire Capital Construction Fund program. The proposal should not be adopted.

B. Competitive environment facing the U.S. Merchant Marine

The U.S. merchant fleet faces vigorous foreign competition: Seven foreign merchant fleets are larger than that of the U.S. Foreign crew wages and shipbuilding costs are lower than those of the U.S. Foreign shipbuilding is heavily government-subsidized. The 1st, 2d, 6th and 13th largest merchant fleets, representing over 40 percent of world shipping, are not subject to income tax. The 7th and 14th largest merchant fleets operate as government agencies and are not subject to income tax. U.S. companies own foreign ships equalling nearly four times the size of the U.S. merchant fleet, and Congress has exempted the income of these ships from U.S. tax if the income is reinvested in foreign shipping.

In the face of this competition, the U.S. merchant fleet has been carrying a decreasing share of U.S. oceanborne international trade. In recent years, the U.S. fleet's share of this trade has diminished to about 3 percent of the value of tanker trade to and from the U.S., 2 percent of dry bulk cargo trade, and 29 percent of general cargo freighter ("liner") trade.

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[1] For a comprehensive recent discussion of the points in this and the succeeding paragraphs, see Department of Commerce, *U.S. Ocean Policy in the 1970's: Status and Issues*, V-27 ff. (1978).

C. The American response: Parity on three points: Operating costs, construction costs, and tax parity

For many years, there has been agreement that the most efficient method of maintaining U.S. merchant marine capability is by means of a parity policy consisting of three elements: parity of operating costs, parity of capital costs, and tax parity.

Operating cost parity.—Operating costs of U.S. flag ships are higher than those of foreign flag ships mainly because U.S. citizen crews earn higher wages. The Merchant Marine Act requires citizen crews for national defense reasons, but it is the operating companies that pay the wages. The Maritime Administration makes up most of this wage differential in the form of an Operating Differential Subsidy ("ODS"). ODS enables the U.S. commercial fleet to offer shipping rates in parity with those offered by foreign commercial fleets.

Capital cost parity.—Generally, an operating company is eligible for ODS only to the extent its fleet is built in the U.S. To offset the higher capital cost of U.S. built ships and to maintain a strong U.S. shipbuilding base, the Maritime Administration provides a Construction Differential Subsidy ("CDS"), under which payments are made to U.S. shipyards so they can deliver ships at prices in parity with those charged by foreign shipyards. The current Administration has effectively eliminated the CDS program, but Congress has preserved capital cost parity for the time being by extending ODS to ships which will be modernized or built in foreign shipyards but which are registered as part of the U.S. fleet.

Tax parity: the Capital Construction Fund ("CCF") program.—True parity is not achieved until companies in the U.S. international fleet have the opportunity to earn an after-tax return on investment on a par with the after-tax earnings of foreign companies.

Congress has always provided tax parity for earnings of foreign flag ships owned by foreign subsidiaries of U.S. companies. In 1962, when Congress added what is referred to as "Subpart F" in the Internal Revenue Code,[2] imposing tax on the earnings of many U.S. owned foreign corporations, Congress preserved the exemption of shipping earnings from U.S. tax unless the earnings were repatriated to the U.S. in the form of dividends.[3]

In 1970, the U.S. adopted a measure of tax parity for the U.S. flag fleet in the form of the Capital Construction Fund program, under which, generally, operators of U.S. ships are allowed to defer taxes on earnings contributed to government-supervised Capital Construction Funds for reinvestment in future ship construction for the U.S. international merchant fleet. The CCF program is the key element in putting U.S. ships on a tax footing nearly on a par with that of U.S. owned foreign ships under Subpart F.

The unanimous Senate Report on the original CCF bill still is the best description of the reasons for the goals of the program:

"Many countries give their merchant marine substantial assistance for shipbuilding. Unsubsidized American flag operators, however, receive no effective tax or other assistance to help them replace their vessels or obtain additional vessels, except depreciation that is available to all industries * * *. [E]arnings of foreign corporations derived from the operation of foreign-flag vessels * * * [p]ay no income taxes either to their country of registry or to the United States. These foreign corporations, therefore, have the opportunity to replace their vessels, or to acquire additional vessles, with untaxed funds. Since corporations that own unsubsidized American-flag vessels that compete with foreign-flag vessels are taxed on all their income wherever earned, they are at a disadvantage with respect to replacement of their vessels or acquisition of additional vessels.

"To overcome this disadvantage of unsubsidized American flag vessels, this bill extends the tax deferral privileges, now generally available only in the case of subsidized ships, to ships acquired for use in nonsubsidized foreign trade * * *."[4]

Even in 1975, when Congress amended Subpart F so as to impose tax on a much broader range of foreign subsidiaries' earnings, Congress preserved deferral for foreign shipping earnings reinvested in shipping operations. This preserved the tax parity between U.S. owned foreign flag and U.S. owned U.S. flag vessels.

D. The impact of Treasury's Feburary 1982 tax proposal

Treasury's proposed new minimum tax would bring about a major change in this parity policy. The Treasury proposal would tax deposits into Capital Construction

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[2] Internal Revenue Code of 1954, as amended (26 U.S.C.) (the "Code"), §§ 951–964.
[3] Code § 954(b)(2) as in force before the effective date of the Tax Reduction Act of 1975.
[4] S. Rep. No. 91-1080, 91st Cong., 2d Sess. 42 (1970).

Funds whether they were made from taxable income or not, would impose a double minimum tax burden on U.S. shipping because of a subsequent disallowance of depreciation, and would impose tax on CCF deposits required under thousands of binding CCF agreements already in force between vessel operators and the federal government.

The principal purpose of the Treasury proposal appears to be the generation of revenue to defray budget deficits. This memorandum concludes, based on the government's own estimates, that the proposed tax on CCFs will generate less than 1 percent of the revenues produced by the minimum tax, but that the cost of the proposed tax is the repeal of tax parity for the U.S. flag fleet and the likely destruction of the CCF program.

II. THE CAPITAL CONSTRUCTION FUND ("CCF") PROGRAM

A. The CCF statutory, regulatory and contractual framework

The present CCF program was devised in 1970 by the Senate Committee on Commerce and the House Committee on Merchant Marine and Fisheries. The relevant law is part of the Merchant Marine Act, 1936, as amended in 1970. The Maritime Administration, in the Department of Transportation, administers the program.[5] There is also a relatively small Construction Reserve Fund ("CRF") program administered by the Maritime Administration which is similar to CCF in some respects but which is available only for deposits of proceeds of sales of certain ships. See n. 11 below.

A Capital Construction Fund is a form of savings account. Each CCF account relates to one company. The account is built up by deposits by a U.S. company out of its earnings from operating U.S. ships. The Maritime Administration supervises the operation of all CCF accounts.

To participate in the CCF program, a company must make an application to the Maritime Administration. The application must include a detailed plan describing, generally, current vessel operations, expected earnings, and a program of future construction of new U.S. flag ships, including the kinds of new vessels, their cost, their construction dates, and the role the CCF is proposed to play in financing them. The applicant must also demonstrate the financial capability to implement the entire plan. If the application is accepted, the company must enter into a detailed contract with the Maritime Administration promising to carry out the plan as described.[6]

Generally, each contract states what earnings are to be contributed to the CCF. In general, contributions are limited to: (a) taxable income from operation of specified vessels, tax depreciation on those vessels, proceeds of any sale of these vessels, plus income of the assets in the CCF; or, if less, (b) the amounts needed, on a current basis, to fund the planned future construction.

Once contributed to the CCF, the money in the account may only be invested in certain kinds of assets specified in the law. Each company with a CCF makes detailed reports to the Maritime Administration every six months on the activities of the CCF account.

Earnings contributed to a CCF give rise to deductions on the company's federal tax return. The deductions, of course, reduce the company's income taxes. The higher a company's income is—that is, the more competitive the company is—the greater the incentive to become part of the CCF program and the faster that capital for new ships can accumulate.

A withdrawal from a CCF account that is for construction or acquisition of a new ship or its equipment as planned is a "qualified" withdrawal under the CCF contract. A withdrawal that is not in accordance with the plan and the contract is a "nonqualified" withdrawal. Both kinds of withdrawals have the effect of "recapturing" the deductions taken earlier when contributions were made.

Upon a qualified withdrawal, the ship that is built will have no basis for tax purposes to the extent it is built with CCF funds. Since there will be no basis, there will be no depreciation. Without depreciation, deductions will be foregone and the company's income taxes will be increased.

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[5] Section 607, Merchant Marine Act, 1936 (46 U.S.C. § 1177), as added by the Merchant Marine Act of 1970. The relevant regulations are at 46 CFR Parts 390 and 391.

[6] See Appendix B, Sample CCF Agreement. The entire CCF program is carried out under the terms of such contracts. However, it is each shipping company, not the Maritime Administration, which selects the kinds of new ships to be built with CCF funds and chooses the trade routes on which to use the new ships. The result is that the CCF program deploys capital along lines of market-directed, not government-directed, investment decisions.

Upon a nonqualified withdrawal, the amount withdrawn will be immediately fully taxable, will give rise to interest owing to the Treasury running from the time of deposit, and may cause the Maritime Administration to terminate the agreement, resulting in the entire CCF account being added to taxable income and giving rise to additional interest owing to Treasury.[7]

B. CCF as the difference between having capital to invest or not

From the viewpoint of many companies with CCFs, the program makes the difference between having the capital to invest in new ships and new technology, or not having the capital at all. Many shipping companies are part of consolidated groups of companies where there are competing demands for capital. This competition can involve factors other than efficiency and can be unduly influenced by the investment trends of a current year, often with eventual unfavorable results. When a shipping subsidiary has a CCF, the capital in the CCF is almost always safe from being diverted to other investments because of the taxes and interest due on a nonqualified withdrawal. The result is that the money which was saved for new ships will in fact be used to build new ships. Without CCF the ships would not be built at all.

From the viewpoint of other companies with CCFs, the program operates as a savings account to accumulate the capital to build new ships. A steady flow of pre-tax earnings, accumulated and reinvested, as in a CCf, on a pre-tax basis, will grow almost twice as fast as a similar flow of after-tax earnings, accumulated and re-invested on an after-tax basis. Being able to put new ships into service twice as fast can be necessary for a company's very survival and is essential to support the competitiveness of the U.S. fleet.

C. Documentation that the program works

Through the first decade of the present CCF program, CCFs have disbursed funds for full or partial funding of $5.2 billion in ship construction or modernization.[8] This does not mean that $5.2 billion was contributed to and withdrawn from CCFs during that time. Instead, this figure results from the capability of the program to take a contribution and multiply it into a higher figure representing ship reconstruction or new construction. This multiplier effect results in part from the ability of a CCF to earn and retain pre-tax income. The multiplier effects also results from the incentive each company has to use CCF withdrawals as a ¼ or ⅓ down payment only, so that the rest of the purchase price of each ship, being derived from after tax dollars, will provide a company at least some depreciation deductions. The actual multiplier effect of the program is such that about $2.60 in new ship construction takes place for every $1.00 paid from shipping earnings to a CCF.

Cumulative contributions to CCFs during the first decade of the program's operation were $2.3 billion. During this time, annual contributions to CCFs rose from $25.2 million during the first year to a record high of $406.9 million in 1980.[9]

Also during this time, the total amount on deposit in CCFs rose from $17.9 million to a record $510.9 million.[10] This $510.9 million, with future contributions, will be used for full or partial funding of projects totalling an additional $5.3 billion in replacement vessels.[11]

There were small nonqualified withdrawals from CCFs in 1970–1980. Most of these were a result of completion of companies' plans at a lesser cost, or a result of changes in plans resulting in CCF accounts having excess funds. All nonqualified Maritime Administration CCF withdrawals totalled less than $82 million, or about 3.5 percent of total deposits.[12]

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[7] The CCF program is also available to the fisheries industry under a program administered by the National Oceanic and Atmospheric Administration ("NOAA") in the Department of Commerce. See n. 11 below.

[8] MarAd '80, Annual Report of the Maritime Administration for Fiscal Year 1980, 4.

[9] Table 4.

[10] Table 5.

[11] MarAd '80, 4. Also to be added to the foregoing statistics are net contributions to Construction Reserve Funds in Fiscal Year 1980 of $5.4 million, resulting in a total fund balance as of September 30, 1980, of $15.5 million. Id. at 13.

In addition, the fisheries industry CCF's ("FCCFs") attracted $412 million in deposits from 1970 to 1982. Active FCCFs totalled 2762 as of 1982, with net deposits of $122 million. The multiplier effect of the FCCF program appears to be about $4.00 to $1.00, based on unpublished data provided by NOAA.

[12] Maritime Administration, "Capital Construction Fund (CCF) Program Statistics Update for 1980" (unpublished).

III. TREASURY PROPOSAL TO TAX CCFS: DESCRIPTION; REVENUE YIELD

A. Imposition of the tax on capital construction funds

Congress has created a number of tax incentives, most often deductions, in order to encourage investment or business in certain sectors of the economy. In the case of six of these tax provisions, Congress has diluted the incentive by imposing a "minimum tax" on some, but not all, of the taxpayers who are using these provisions.

On February 26th of this year, Treasury proposed a revised minimum tax which, it appears, is intended not so much to dilute incentives but rather to generate revenues to cut the projected budget deficits. Treasury's revised list of tax incentives subject to minimum tax encompasses fourteen provisions, including some provisions added as recently as in the Economic Recovery Tax Act of 1981. Capital Construction Funds are proposed to be part of the revised minimum tax base. The entire text of the Treasury proposal with respect to Capital Construction Funds is as follows: "*Certain shipping income.* A new item added back to the corporate minimum tax base will be amounts deposited in construction reserve funds or capital construction funds under the Merchant Marine Act."[13]

The proposed minimum tax is an alternative tax. To calculate a company's minimum tax, the company would first calculate its normal taxable income and its normal corporate tax. The company would then calculate its "total minimum tax base", which consists of the sum of its taxable income, plus its tax incentive deductions, including CCF or CRF deposits, plus income of the CCF fund. The minimum tax would be 15 percent of the total minimum tax base. The company would pay the higher of the two alternatives, the normal corporate tax or the minimum tax.

The 15 percent minimum tax rate has the effect of reimposing approximately one-third (15/46) of the normal corporate tax. However, it makes no provision for restoring one-third of the disallowed basis in a CCF-constructed vessel.

The new minimum tax would apply to deposits made under all CCF agreements with the Maritime Administration (and, presumably, all CCF agreements in the fisheries industry with the National Oceanic and Atmospheric Administration) whether the agreements had been entered into before the date of the Treasury proposal or not. The tax would apply to deposits made whether the deposits were made from income or not. The tax would not apply, however, to deposits made by U.S owners of foreign flag vessels into saving funds for future construction of new foreign flag ships.

Minimum tax liability would not be eligible to be offset by investment tax credits. It would be offset by foreign tax credits. The payment of minimum taxes would give rise to a tax credit carryforward. The credit, equal to minimum taxes previously paid, could be carried forward for 15 years and would be available to offset normal income tax liability.

B. Revenue analysis

The new minimum tax would impose a tax burden on U.S. business almost ten times that of the present minimum tax. The present minimum tax raised an estimated $500 million in 1981,[14] while the new minimum tax would raise as much as $4.8 billion in 1984.[15] The portion of proposed minimum tax revenues represented by taxes collected from companies with CCF's however, is a tiny amount, as indicated in Table 7. In 1983, the year of greatest yield from taxing CCF deposits, the new minimum tax woud raise at most 1.2 percent of its total revenue from companies with CCF's. By 1987, this percentage figure will shrink to at most 0.3 percent. The contribution which the proposed minimum tax on CCF would make to the projected budget deficits in proportionately almost too small to measure. The cost to the U.S merchant fleet, however, of the proposed minimum tax on CCF is to repeal tax parity with our foreign flag competitors and to threaten the destruction of the entire CCF program, as is explained below.

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[13] Department of the Treasury, "General and Technical Explanations of the Tax Revision and Improved Collection and Enforcement Proposals" (February 26, 1982) (hereinafter "Treasury Technical Explanations"), S-16. References to the Treasury Technical Explanations in this analysis are to Bureau of National Affairs, Special Supplement, Daily Executive Report No. 39 (February 26, 1982).

[14] Id. at S-14.

[15] Id. at S-15.

IV. THE TREASURY PROPOSAL THREATENS THE ENTIRE CCF PROGRAM FOR LESS THAN 1 PERCENT OF MINIMUM TAX REVENUES

A. The treasury proposal would eliminate tax parity for the U.S. merchant marine and would reintroduce the tax bias in favor of U.S. investment in foreign ships

The policy of tax parity is based on a decision that for the United States to have an adequate merchant fleet, earnings of companies operating U.S. vessels competing with foreign companies operating foreign vessels must be eligible for approximately equal tax treatment of those earnings. Acceptance of the Treasury minimum tax proposal would be to reverse this decision and to scrape the tax parity policy. The proposed minimum tax has a 15 percent rate, which is about one-third of the usual corporate rate of 46 percent. It is meaningless to state, however, that the Treasury proposal preserves two-thirds of parity. The U.S. either does have a parity policy or it does not. A fraction of parity is no parity.

The Treasury proposal would have no impact on the earnings of U.S. companies' controlled foreign corporation subsidiaries operating foreign flag ships. This shipping capacity, which is four times the size of the entire U.S. flag fleet, pays relatively little tax to the U.S. because tax on its earnings is indefinitely deferred to the extent these earnings are "reinvested" in shipping assets. The relevant provisions in the Internal Revenue Code, called the "reinvestment exclusion",[16] and the related regulations,[17] in effect allow deferral of tax for reinvestments in a range of foreign assets far wider than that permitted under CCF.

Nevertheless, since CCF provides tax deferral for reinvestments in vessels, which are the most capital-intensive assets in the industry, CCF provides a measure of tax parity with Subpart F. By repealing this parity policy, the Treasury proposal would creat a bias in the Internal Revenue Code toward U.S. investment in foreign flag ships. For the foreseeable future under the minimum tax proposal, U.S. companies would achieve a higher return on investment by registering vessels overseas and serving U.S. trade routes with foreign flag rather than U.S. flag vessels. The result would be inevitable erosion in the capability of the U.S. flag fleet.

B. The proposal renders the CCF program a total loss to companies for which CCF is the difference between having capital for replacement vessels or not.

In the case of companies in the U.S. fleet which are subsidiaries of other diversified companies, most of these companies would not, after enactment of the Treasury proposal, use CCF as a way to accumulate funds for new vessel construction. In the case of most of these companies, without CCF, orders for new vessels will simply not be placed.

In the case of a company that did enter into a CCF agreement after any enactment of the proposed minimum tax, it would be able to accumulate funds for initial equity investment in new vessels only slightly faster than if there were no CCF. Slowing down the U.S. merchant fleet's ability to take advantage of new technology in this fashion will mean that owners of foreign-flag vessels will be able to put new capability into place almost twice as fast as the U.S. fleet.

In every case, the result is the elimination or the delay of new ship construction and new, competitive technology. The overall result would be the swift decline of the U.S. international fleet.

C. The effective minimum tax rate on the U.S. maritime fleet will be double the rate on other industries

Contributions of ordinary income into a CCF give rise to deductions, but, as described above, the tax basis of a new vessel later built with disbursements from CCF is reduced by an identical amount. The minimum tax would repeal about one-third of the deduction for CCF contributions (by reimposing a 15 percent tax as compared to the 46 percent regular tax) but would give a company no basis for the minimum tax paid. This would create a double minimum tax on the shipping industry only.

Example. A company would pay a $15 tax on a $100 contribution to its CCF. This is the first tax.

Assume the company later withdrew the $100 to build a new ship. The ship would normally have a basis of $100, but this basis (and related depreciation) will be reduced to $0 because of the existing "recapture" provisions. The tax cost of the disallowed depreciation will be 46 percent times $100, or $46. Since the company paid one-third of the regular tax, it should be entitled to one-third of the regular basis, or

[16] Code §§ 954(b)(2), 954(f), and 955.
[17] Prop. Treas. Reg. § 1.955A-2.

$23. The tax cost of the $33 of disallowed depreciation will be 46 percent times $33, or $15. This is the second tax.[18]

Thus a company in the shipping industry would pay a minimum tax not at a 15 percent rate but at a 30 percent rate; 15 percent on contributions to CCF, and another 15 percent after new CCF-built ships are placed in service.

D. The minimum tax on CCF would tax ACRS depreciation and would erode the benefits of the investment credit and the net operating loss provisions

In the case of CCFs, the Treasury proposal could classify depreciation on a vessel, including "ACRS" depreciation, as a tax preference.

Contributions to a CCF may be made to the extent of depreciation on an existing vessel.[19] However, CCF contributions of depreciation amounts do not give rise to deductions, so it is difficult to see why they should be classified as "preferences" subject to a minimum tax. Nevertheless, this is what would happen under the new minimum tax. In effect, this aspect of the minimum tax turns normal depreciation on ships into preference deductions. New vessels will in the future be depreciated, to the extent they have depreciable basis, under the Accelerated Cost Recovery System ("ACRS") enacted as part of the Economic Recovery Tax Act of 1981. It is hardly likely that Treasury would propose that ACRS be classified as a tax preference, but that is the effect of this provision.

The proposed minimum tax can impose additional tax burdens on a company even if the company has no preference income. A shipping company that did not use CCF but that had substantial investment credits could easily be required to pay additional minimum tax. This wrong-headed result applies not just to shipping companies. Treasury's announcement of the minimum tax admits as much.[20]

The minimum tax would also erode the benefits of the Revenue Code's net operating loss ("NOL") carryover provisions. In some recent years, shipping companies have experienced losses because of subsidized and tax-exempt foreign competition. When such a company regains its profitability it uses the NOL carryover provisions to generate much-needed cash flow by, in effect, averaging loss years and profit years for tax purposes. Under the proposed minimum tax, when NOL carryovers reduce a company's regular tax, minimum tax could be owed whether a company had preferences or not.[21] Moreover, a company which thus had been "disallowed" some of the benefit of its NOL carryover would not be able to carryover the disallowed portion to another year.

These problems will all apply at once to capital-intensive industries, with lean profits, just starting a comeback from a sectored downturn or a downturn such as the 1981–82 recession. The U.S. shipping industry is just one of many industries which fits this pattern.

E. The minimum tax as proposed would apply even to binding contracts with the Federal Government, and would create numerous conflicts with the CCF regulatory framework

The Treasury proposal fails to recognize that it will have a disastrous impact on the existing 2,900 binding CCF Agreements that companies have with the federal government. By contrast, Treasury has gone out of its way to exempt leases entered into before the date of publication of the Treasury Technical Explanations from the impact of the minimum tax. Moreover, elsewhere in the Treasury announcement, Treasury has proposed to exempt long-term contracts entered into on or before the date of the announcement from the repeal of the long-term contract method of tax accounting.[22] Since investments in buildings, plant and equipment under a pre-existing binding contract are often exempted from the impact of (or benefits of) new tax provisions, it is logical to think that if Congress enacts an expanded minimum tax, it will also exempt existing CCF agreements from the tax.

Depending on whether existing agreements are exempted or not, and in some cases even if they are exempted, the imposition of the minimum tax could create

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[18] The minimum tax credit carryforward might alleviate the problem caused by the disallowance of basis, but not if the credit had already been used up on other shipping earnings, not if the company had low profits and continued to pay minimum tax, and not if, as a result, the credit carryforward period expired.

[19] Merchant Marine Act, 1936, § 607(b)(1)(B).

[20] See Treasury Technical Explanation, S–15; in Example 2 on that page, minimum tax would still be owed in the absence of preferences. Generally, if a company had no preferences but had investments equal to 3.2 times taxable income, it would have minimum tax because of the investment credit.

[21] See Treasury Technical Explanations, S–15, Example 3.

[22] Treasury Technical Explanations, S–16, S–5.

numerous legal issues between the Maritime Administration and companies with CCFs.

Example 1. If the imposition of the minimum tax forced a company to shrink its ship modernization or shipbuilding program, and the effect of the shrinkage was to leave some contributions surplus in the fund, the result would normally be a nonqualified withdrawal, which has very harsh tax consequences.[23]

Example 2. If a company diverted cash from its planned CCF contributions in order to pay minimum tax, the company could be in violation of the CCF minimum deposit rules.[24]

Example 3. Assets in a CCF must be income-producing assets and the resulting income must be deposited into the CCF. Thus a company with a CCF is under a contract with the government requiring the company to receive income which is in turn required to be contributed to the CCF and therefore, under the Treasury proposal, required to generate minimum tax. What is more, under the terms of the standard CCF agreement, the company would not be able to use a withdrawal from the CCF to pay the tax.[25]

A likely result of the enactment of the minimum tax would be that the Maritime Administration would regard imposition of the tax, for a given company, as "circumstances beyond its control", preventing it from fulfilling its CCF plans, or "as a change in circumstances which makes the completion of its program economically unfeasible", which, upon the written acquiescence of the Maritime Administration, would result in permission to make a withdrawal from the CCF.[26] Alternatively, a company might seek to terminate a CCF agreement by pointing out that imposition of the minimum tax is a change in the CCF "rules and regulations" which would have a substantial effect on the rights or obligations of the company.[27] In these cases, legislation may be necessary to prevent the withdrawal or termination from giving rise to the full adverse consequences of a nonqualified withdrawal—usually, substantial tax and interest on the company with the CCF.

In any case, the probable result would be to take billions of dollars out of the present base of $5.3 billion in CCF construction plans,[28] and the virtual dismantling of the CCF program. This is a disproportionately severe price to pay for the insignificant revenue which the minimum tax on CCFs will generate.

V. THE TREASURY PROPOSAL IS OUT OF STEP WITH SOUND MARITIME POLICY AND OUT OF STEP WITH PROMISED ADMINISTRATION MARITIME INITIATIVES

A. Role of CCF in sound maritime policy for the 1980's

The Capital Construction Fund program can and should play a major role in government policies for the U.S. merchant marine for the 1980's. The concepts underlying the present system are sensible and workable, and the results under the present program are provable, as demonstrated above. The emergence of new competitive forces in international shipping and the realization that there are new possible theaters of naval operations for U.S. forces, such as the Indian Ocean and the South Atlantic Ocean, support an expansion, not a contraction, of the partnership between the U.S. merchant marine and the U.S. government. These factors do not call for the contraction of CCF, which would be the inevitable result of enactment of the Treasury minimum tax proposal. Instead, these factors call for the refinement and expansion of the CCF program.

CCF is a program that works. The future of this program is to build on it and streamline it, rather than to indulge in a back door repealer of its tax provisions—a repealer which threatens the entire CCF program.

B. Contrary to the direction of the Treasury proposal, the administration as a whole is preparing a maritime policy which should expand CCF

Showing his agreement with the above analysis, President Reagan has pledged his Administration to vigorous support for a strong maritime fleet for the 1980's. In his major statement on the issue, he stated: "* * * A specific-maritime program must be developed that will * * * restore the cost competitiveness of U.S.-flag operators in the international market place. * * * [O]ur parity system failed in the mid-1970's because most foreign Governments moved to protect their own vital maritime interests after the shipping collapse of the mid-1970's. We must now take corrective

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[23] 46 CFR 390.10(b)(3)(iv).
[24] 46 CFR 390.7(e)(3)–(6).
[25] 46 CFR 390.8; Sample Agreement, Art. 5(B)(1).
[26] 46 CFR 390.10 (b)(3)(iv) and (b)(1).
[27] Sample Agreement, Art. 4.A(2).
[28] See pp. 7–9 above.

action to make certain our merchant fleet and our shipbuilding industry survive and grow." [29]

The President's fiscal year 1983 Budget Message states that the Administration: "* * * is conducting a full review of maritime policies including the need for subsidies, the importance of both the shipbuilding capability and the merchant marine to national defense, the impact of planned increases in naval shipbuilding, ways to increase commercial participation in military support functions, and the effect that new tax policies and possible trade agreements may have on improving the competitiveness of the U.S. Merchant Marine."

By reliable reports, the Administration's proposed maritime program includes an expansion of the CCF program. The Treasury's proposal to impose a tax on deposits into CCF's is out of step with these promised Administration initiatives and is wholly contradictory to them.

V. CONCLUSION: THE TREASURY PROPOSAL SHOULD NOT BE ENACTED

CCF is a federal program that works.

In the years since the Maritime Administration put the program into effect in 1970, the program has attracted $2.3 billion in deposits for modernization and expansion of the U.S. merchant fleet. Disbursements from CCFs have provided or are providing full or partial funding for $5.2 billion in ship modernization and construction.

In the face of this proven performance, Treasury's proposal represents bad tax policy, bad maritime policy, and bad economics.

Bad tax policy, because the proposal would repeal the current U.S. tax parity with the foreign taxes imposed on foreign fleets, would reintroduce the tax bias in favor of U.S. investment in foreign ships—a bias which CCF was intended to reduce in the first place—and, because of the CCF recapture rules, would impose an effective tax rate on shipping equal to twice the rate on other industries.

Bad maritime policy, because the proposal would be a "backdoor" repeal of a program created by the Merchant Marine Act and run by the Maritime Administration, would contradict the terms of thousands of binding contracts with the federal government and because the Executive Branch has promised shortly to deliver a comprehensive policy for the modernization of the U.S. merchant marine which by all accounts involves an expansion of the CCF program.

Bad economics, because the tax on CCF would be a "bookkeepter's bandaid on a budget hemorrhage." The tax on CCF would raise less than 1 percent of minimum tax revenues but would have the effect of repealing the CCF program. Once U.S. tax parity is lost, there would be no incentive to invest in U.S. vessels for the international trades.

For all these reasons, the Treasury proposal should be withdrawn and not enacted.

APPENDIX A

THE COUNCIL OF AMERICAN-FLAG SHIP OPERATORS

The Council of American-flag Ship Operators ("CASO") is a national trade association with headquarters in Washington, D.C., dedicated to the promotion of laws and regulations assuring equal participation for all ocean carriers in the international trade of the United States. To this end CASO represents U.S. flag shipping interests before U.S. Government agencies and various international organizations.

CASO's membership includes: American President Lines, Ltd., Delta Steamship Lines, Inc., Farrell Lines, Inc., Lykes Bros. Steamship Co., Inc., Moore McCormack Lines, Inc., Prudential Lines, Inc., and United States Lines, Inc.

CASO's member companies own and operate a modern, diversified fleet of 161 liner ships, including break-bulk, barge carrier, container, and roll-on/roll-off vessels. These vessels employ approximately 10,000 American merchant seamen, and serve approximately 1,000 ports on six continents, in the carriage of our ocean-borne trade.

CASO's member companies have in the past transported substantial quantities of military cargoes, and all of their ships are available for use by the United States Government during times of military emergency.

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[29] Speech of September 15, 1980.

APPENDIX B—SAMPLE CAPITAL CONSTRUCTION FUND AGREEMENT

[Contract No. MA/CCF—]

CAPITAL CONSTRUCTION FUND AGREEMENT WITH

This Capital Construction Fund Agreement ("Agreement"), made on the date hereinafter set forth, by and between the United States of America, represented by the Maritime Administrator, Department of Transportation ("Maritime Administrator"), and ————, a corporation organized and existing under the laws of the State of ———— ("Party"), a citizen of the United States of America.

Whereas: 1. The Party has applied for the establishment of a Capital Construction Fund ("Fund") under section 607 of the Merchant Marine Act, 1936, as amended ("Act");

2. The Party is the owner or lessee or has contracted for the construction of one or more eligible vessels as defined in section 607(k) of the Act, which vessels are listed in Schedule A hereof;

3. The Party has a program for the construction or acquisition of qualified agreement vessels as defined in section 607(k) of the Act, which program is described in Schedule B hereof;

4. The Maritime Administrator and the Party desire to enter into an Agreement for the purpose of providing replacement vessels, additional vessels, or reconstruction vessels, built in the United States and documented under the laws of the United States for operation in the United States foreign, Great Lakes, or noncontiguous domestic trade;

5. The Maritime Administrator has determined that the Party qualifies for an Agreement under the Act; and

6. The Maritime Administrator has authorized the award of an Agreement upon the terms and conditions set forth herein subject to the Act, as it may be amended from time to time, and such rules and regulations as shall be prescribed by the Secretary of Transportation or his delegate, either alone or jointly with the Secretary of the Treasury, as necessary to carry out the powers, duties, and functions vested in them by the Act ("rules and regulations").

Now, therefore in consideration of the premises the Maritime Administrator and the Party hereby agree as follows:

1. *Establishment of a Fund:* (A) A Fund is hereby established for the purposes set forth in Article 2 hereof, pursuant to such terms and conditions as shall be prescribed in this Agreement, the Act, or the rules and regulations.

(B) The Fund shall be established in the depositories listed in Schedule C hereof.

2. *Purpose of the Fund:* The Fund established hereunder shall be utilized to provide for replacement vessels, additional vessels, or reconstructed vessels, built in the United States and documented under the laws of the United States for operation in the United States foreign, Great Lakes, or noncontiguous domestic trade, and to provide for qualified withdrawals to achieve the program set forth in Schedule B hereof.

3. *Term of the Agreement:* This Agreement shall be effective on the date of execution by the Maritime Administrator and shall continue until terminated under Article 4.

4. *Termination of Agreement:* (A) This Agreement may be terminated at any time under any of the following circumstances:

(1) Upon written mutual agreement by the parties:

(2) Upon written notice by the Party that a change has been made in the rules and regulations which would have a substantial effect upon the rights or obligations of the Party.

(B) This Agreement shall terminate upon completion of the program as set forth in Schedule B hereof.

(C) Upon termination of this Agreement pursuant to paragraphs (A) and/or (B) hereof all amounts remaining in the Fund shall be treated as if withdrawn in a nonqualifed withdrawal (as that term is defined in the Act and the rules and regulations) on the date of termination of this Agreement.

5. Deposits to be made into the Fund: (A) Subject to any restrictions contained in the Act, the rules and regulations, or this Agreement, the Party may deposit, for each taxable year to which this Agreement applies, amounts representing:

(1) Taxable income attributable to the operation of the vessels listed in Schedule A or B hereof;

(2) The depreciation allowable under section 167 of the Internal Revenue Code of 1954, on the vessels listed in Schedule A or B hereof;

(3) The net proceeds from the sale or other disposition of any of the vessels listed in Schedule A or B hereof; and

(4) The net proceeds from insurance or indemnity attributable to the vessels listed in Schedule A or hereof.

(B) The Party shall deposit for each taxable year to which this Agreement applies:

(1) All receipts from the investment or reinvestment of amounts held in the Fund, except that the Party shall not be permitted to deposit more than is necessary to complete its program set out in Schedule B hereof; and

(2) The net proceeds from the mortgage of any vessel listed in Schedule B hereof for which qualified withdrawals from the Fund have been made.

(C) Notwithstanding anything in paragraph (A) or (B) hereof to the contrary, the Party shall make the minimum deposits set forth in Schedule D hereof at the time and in such amounts as may be set forth therein. The Party specifically agrees to deposit up to one hundred percent of allowable taxable income attributable to the operation of agreement vessels in order to meet its obligations under this paragraph.

(D) In the event that any leased vessel listed in Schedule A hereof is included in another capital construction fund agreement, the maximum amount of depreciation which the Party may deposit in respect to that vessel shall be calculated by using the allowable percentage of the depreciation ceiling listed for that vessel in Schedule A hereof.

6. *Withdrawals from the Fund:* (A) The Party may make such qualified withdrawals (as that term is defined in the Act and the rules and regulations) as shall be necessary to fulfill the obligations set forth in Schedule B hereof. Any such qualifed withdrawal may be made without the consent of the Maritime Administrator, except as required by the rules and regulations.

(B) Any other withdrawal from the Fund shall be made only upon the prior written consent of the Maritime Administrator, as required by the rules and regulations.

7. *Investment of the Fund:* (A) The Party, at its discretion, may invest assets held in the Fund in accordance with the Act and the rules and regulations.

(B) The Party agrees that when investing assets held in the Fund to make such investments as will insure that sufficient cash is available at the time qualified withdrawals are required in accordance with the program described in Schedule B hereof.

8. *Pledges, Assignments and Transfers:* (A) The Party agrees not to assign, pledge or otherwise encumber, either directly or indirectly or through any reorganization, merger, or consolidation, all or any part of this Agreement, the Fund, or any assets in the Fund without the prior written consent of the Maritime Administrator; provided, however, the Party may transfer the assets of the Fund, in whole or in part, to an investment trustee, as provided in the rules and regulations.

(B) The Party shall not obligate any assets in the Fund as a compensating balance.

(C) The Party may not sell, transfer or otherwise dispose of any vessel, or part thereof, described in Schedule B hereof without the prior written consent of the Maritime Administrator.

9. *Records and Reports:* (A) The Party and each affiliate, domestic agent, subsidiary or holding company connected with, or directly or indirectly controlling or controlled by the Party shall keep his books, records, and accounts relating to the maintenance, operation, servicing of the vessel(s) and/or service(s) covered by this Agreement in such form as may be prescribed by the Maritime Administrator under the rules and regulations.

(B) The Maritime Administrator agrees not to require the duplication of books, records and accounts required to be kept in some other form by the Interstate Commerce Commission or the Secretary of the Treasury, so long as the information required in paragraph (A) hereof is made available to the Maritime Administrator.

(C) The Party agrees to file, upon notice from the Maritime Administrator, balance sheets, profit and loss statements, and such other statements of financial operations, special reports, charters, ships' logs, memoranda of facts and transactions, as in the opinion of the Maritime Administrator may affect the Party's performance under this Agreement.

(D) The Maritime Administrator may require by regulation that any of such statements, reports and memoranda shall be certified by independent certified public accountants acceptable to the Maritime Administrator.

(E) The Maritime Administrator may require the Party to establish and maintain systems of control of expenses and revenues in connection with the operation of the agreement vessel(s).

(F) The Party agrees to submit promptly to the Maritime Administrator any contract executed in connection with the program described in Schedule B hereof.

(G) The Maritime Administrator is hereby authorized to examine and audit the books, records, and accounts of all persons referred to in this Article whenever he may deem it necessary or desirable.

10. *Modification and Amendment:* This Agreement may be modified or amended at any time by mutual written consent.

11. *Incorporation of Schedules:* This attached Schedules A, B, C, and D are incorporated into and made a part of this Agreement.

12. *Liquidated Damages:* (A) In the event that the Party operates any qualified agreement vessel described in Schedule B hereof in geographic trades other than those permitted by section 607 of the Act, this Agreement, and/or the rules and regulations, the Party shall pay to the United States an amount of liquidated damages for each day of such impermissible geographic trading which shall constitute the time value of the deferral of Federal income tax which the Party has received. The amount shall be calculated in accordance with the rules and regulations.

(B) The Party agrees to pay the daily rate of liquidated damages to the Maritime Administor, for deposit in the Treasury of the United States, within the time limits provided for in the rules and regulations.

(C) Nothing in this Article shall in any way be construed to diminish or waive any of the Maritime Administrator's other remedies for breach under the Act, the Agreement, or the rules and regulations.

(D) Notwithstanding the fact that the Agreement may be terminated pursuant to the provisions of Article 4 hereof, or otherwise, the provisions of this Article 12 shall continue in effect as follows:

(1) In the case of a vessel constructed or acquired within one year of final delivery from the shipyard after construction with the aid of qualified withdrawals, for a period of twenty (20) years from the date of such vessel's final delivery;

(2) In the case of a vessel reconstructed or acquired more than one year after final delivery from the shipyard after construction with the aid of qualified withdrawals, for a period of ten (10) years from the date of such vessel's final delivery from the shipyard after reconstruction or the date of such vessel's acquisition; and

(3) In the case of a vessel included in Schedule B hereof as a qualified agreement vessel in regard to which qualified withdrawals from the Fund have been made to pay existing indebtedness, for a period of ten (10) years from the date of the first qualified withdrawal in regard to such vessel, provided, however, that if such vessel was more than fifteen (15) years old on the date of the first qualified withdrawal in regard thereto, such conditions shall continue for a period of five (5) years in regard to such vessel.

13. *Warranties and Representations by the Party:* The Party hereby warrants and represents that:

(A) The Party is a citizen of the United States within the meaning of section 2 of the Shipping Act, 1916, as amended, and will contine to be so for the term of this Agreement. The Party agrees that, each year, within thirty (30) days after the annual meeting of its stockholders, it shall file a supplemental affidavit as evidence of its continuing United States citizenship, provided that any changes in data last furnished with respect to officers, directors, and stockholders holding five percent or more of the issued and outstanding stock of each class or series which would result in a loss of the Party's status as a United States citizen shall be promptly reported to the Maritime Administrator.

(B) The Party owns, is the lessee, or has contracted for the construction of one or more eligible vessels (within the meaning of section 607(k) of the Act) as listed in Schedule A hereof.

(C) The qualified vessels described in Schedule B hereof: (1) Were or will be constructed or reconstructed in the United States, except as provided in the Act and the rules and regulations;

(2) Are or will be documented under the laws of the United States and will continue to remain so documented; and

(3) Will be operated in the foreign, Great Lakes or noncontiguous domestic trade of the United States within the meaning of the Act and the rules and regulations.

(D) The Party will meet its deposit obligations as agreed upon in Article 5 of this Agreement.

(E) The Party will promptly inform the Maritime Administrator, in writing, of any change in circumstances which would tend to adversely affect the ability of the Party to carry out its obligations under the Agreement.

(F) The Party will faithfully conform to all rules and regulations governing the Agreement and the Fund.

(G) Nothing of monetary value has been improperly given, promised, or implied for entering into this Agreement. The Party further warrants that no improper personal political or other activities have been used or attempted in an effort to influence the outcome of the discussions or negotiations leading to the award of this Agreement. Breach of this warranty shall constitute an event of default for which the Maritime Administrator shall have the right, notwithstanding Article 4, to terminate this Agreement without liability to the United States.

14. *Default in Obligations:* (A) If the Maritime Administrator determines that any substantial obligation under this Agreement is not being fulfilled by the Party, he may, under the rules and regulations and after the Party has been given notice and an opportunity to be heard, declare a breach and treat the entire Fund, or any portion thereof, as an amount withdrawn in a nonqualified withdrawal.

(B) The Maritime Administrator shall provide an opportunity for the Party to cure a breach declared pursuant to Paragraph (A) of this Article 14.

(C) Events of breach by the Party shall include, but shall not be limited to: (1) Failure in any respect to use due diligence in performing the program set forth in Schedule B hereof;

(2) Obligating the assets in the Fund as a compensating balance;

(3) Failure to make deposits required in Schedule D hereof;

(4) Failure to secure written permission from the Maritime Administrator when such permission is required by the rules and regulations;

(5) Failure to submit reports and/or records on a timely basis as provided in Article 9 hereof;

(6) Any material misrepresentation made by the Party or any failure by the Party to disclose material information in connection with this Agreement whether before or after execution hereof and whether made in an application, report, affidavit, or otherwise; or

(7) Failure by the Party to comply with any provisions of section 607 of the act, the rules and regulations, or this Agreement.

15. *Extension of Federal Income Tax Benefits:* The Maritime Administrator agrees that the Federal income tax benefits provided in the Act and the rules and regulations shall be available to the Party if the Party shall carry out its obligations under this Agreement.

UNITED STATES OF AMERICA, MARITIME ADMINISTRATOR, DEPARTMENT OF TRANSPORTATION

(SEAL)
Attest:
By —— (Secretary).
(SEAL)
By —— (Secretary).
Attest:
By —— (Contracting Officer). —— (Secretary).
Approved as to form: (Date of Execution) —— By —— (President).

XYZ CO—SCHEDULE A—ELIGIBLE AGREEMENT VESSELS

Name of vessel	Specific type	Capacity	Owned or leased and owner is leased	Date and place constructed
SS Smith, official No. 236425.	Tanker	56,000 dwt	Leased: ABC Ships, Inc., San Diego, Calif., 50 percent of depreciation ceiling.	1962, American Steel, San Franciso, Calif.
SS Brown, official No. 325111.	do	265,000 dwt	Owned	1974, Southern Shipyards, Mobile, Ala.
SS Jones, official No. 190528.	Container ship	30,000 dwt, 500 400-ft containders.	do	1954, Bond Shipyard, New York, N.Y.
Hercules, official No. 256,125.	Oceangoing tugboat	105 ft 2,000 hp	do	1966, Washington Iron Works, Seattle, Wash.
XYZ–1, official No. 257,164.	Roll-on, roll-off barge	1,200 gr ton, 45 40-ft containers.	do	1966, Washington Iron Works, Seattle, Wash.

XYZ CO—SCHEDULE A—ELIGIBLE AGREEMENT VESSELS—Continued

Name of vessel	Specific type	Capacity	Owned or leased and owner is leased	Date and place constructed
XYZ–2, official No. 260,138.	Roll-on, roll-off barge	1,200 gr ton, 45 40-ft containers.	Owned	1969, Washington Iron Works, Seattle, Wash.
OTC–35, official No. 262,170.	do	1,500 gr ton, 60 40-ft containers.	Leased; Oregon Towing Co., Portland, Oreg., 100 percent of depreciation ceiling.	1969, J. & J. Shipyard, Portland, Oreg.
200 trailers, Nos. 111032–A–10677B–1M through 11032–A–10677B–1M.	Dry cargo	40 ft	Leased; International Leasing Co., New York, N.Y. 0 percent of depreciation ceiling.	1968, Acme Container Corp., New Yor, N.Y.
1,500 containers, Nos. 312 A through 1312 A.	Refrigerated dry cargo	do	Owned	1969, Aluminum Products, Inc., Dallas, Tex.

	Date and place reconstructed	Date documented	Area of operation	Details of service
	(f)	(g)	(h)	(i)
SS Smith, official No. 236425.	Not available	1962	Noncontiguous domestic trade.	Carriage of crude oil from Valdez, Alaska, to west coast of the continental United States.
SS Brown, official No. 325111.	do	1974	U.S. foreign trade	Worldwide carriage of crude oil.
SS Jones, official No. 190528.	1970, Litton Systems, Mississippi.	1954	U.S. foreign and noncontiguous trade.	Container service between Japan and California via Hawaii.
Hercules, official No. 256,125.	Not available	1968	Domestic	Towing roll-on, roll-off barges from Puget Sound to San Francisco.
XYZ–1, officiai No. 257,164.	do	1968	do	Carriage of trailer type containers between Puget Sound and San Francisco.
XYZ–2, official No. 260,138.	do	1969	do	Do.
OTC–35, official No. 262,170.	do	1969	do	Do.
200 trailers, Nos. 111032–A–10677B–1M through 11032–A–10677B–1M.	do	NA	do	For use on Barges XYZ–1, XYZ–2, OTC–35.
1,500 containers, Nos. 312 A through 1312 A.	do	NA	U.S. foreign noncontiguous domestic trade.	For use as complement of SS Jones.

TABLE 1.—MAJOR MERCHANT FLEETS OF THE WORLD—JAN. 1, 1980

Country	Number of ships [1]	Rank by number of ships [2]	Deadweight tons	Rank by dead-weight tonnage
Liberia	2,380	3	158,702,000	1
Greece	2,876	1	63,542,000	2
Japan	1,751	5	61,192,000	3
United Kingdom	1,110	6	41,937,000	4
Norway	632	9	39,494,000	5
Panama	2,347	4	35,257,000	6
U.S.S.R	2,512	2	21,590,000	7

TABLE 1.—MAJOR MERCHANT FLEETS OF THE WORLD—JAN. 1, 1980—Continued

Country	Number of ships [1]	Rank by number of ships [2]	Deadweight tons	Rank by dead-weight tonnage
United States (privately owned)	569	11	20,540,000	8
France	359	17	19,884,000	9
Italy	624	10	18,489,000	10
Spain	506	12	12,656,000	11
Germany (Federal Republic)	502	13	12,485,000	12
Singapore	667	7	12,341,000	13
China (People's Republic of)	645	8	9,372,000	14
India	363	16	9,100,000	15
All others [3]	6,955	.....	114,321,000	.....
Total	24,798	.....	650,902,000	.....

[1] Oceangoing merchant ships of 1,000 gross tons and over.
[2] By number of ships, Cyprus ranked 14th with 457 vessels aggregating 2,991,100 dwt., and the Netherlands ranked 15th with 450 vessels aggreg**ing 8,165,000 dwt.
[3] Includes 296 United States Government-owned ships of 3,049,000 dwt.

XYZ CO., PROGRAM OBJECTIVES—I. ACQUISITION OR CONSTRUCTION OF VESSELS

Vessel name, and official number	General characteristics	Approximate cost	Amount to be withdrawn from fund	Approximate date of—		Anticipated area of operation
				Contract	Delivery	

XYZ CO., PROGRAM OBJECTIVES—II. RECONSTRUCTION OF VESSELS

Vessel name and official number	General characteristics	Approximate cost	Amount to be withdrawn from fund	Approximate date of—		Anticipated area of operation
				Contract	Delivery	

XYZ CO., PROGRAM OBJECTIVES—III. PAYMENT OF PRINCIPAL ON EXISTING INDEBTEDNESS

Vessel name and official number	Purpose of indebtedness	Amount to be paid from fund

XYZ CO., SCHEDULE C—DEPOSITIONS FOR CAPITAL CONSTRUCTION FUND

Name	Address
1. First American Bank checking account	2001 Park Ave., San Francisco, Calif. 94109.
2. Southern California National Bank investment trustee established pursuant to sec. 390.7 of the SOC regulations.	1 Waterfront Place, San Francisco, Calif. 94101.

XYZ CO.—SCHEDULE D—MINIMUM DEPOSITS

[In thousands]

Taxable year	Ordinary income	Net proceeds	Fund interest	Depreciation	Total
1973 to 1975	$3,150	[1] $2,400	$250		$5,800
1976 to 1978	2,900	[2] 1,500	325		4,725
1979 to 1981	3,000		350	85	3,435
1982 to 1984	2,800		74	125	3,000
1985 to 1987	2,850		90	80	3,000
1988 to 1990	2,900		100		3,000
1991 to 1993	3,000		100		3,100
1994 to 1996	3,100		110		3,210
1997 to 1999	3,250		120		3,370
2000	3,200		120	120	3,320
Total					$35,960

[1] Net proceeds from sale of barges XYZ–1 and XYZ–2 for $1,200,000 each.
[2] Net proceeds from sale of tug Hercules.

[41 FR 4265, Jan. 29, 1976, as amended at 42 FR 43632, Aug. 30, 1977]

TABLE 2.—MARITIME ADMINISTRATION CCF FUNDHOLDERS

(AS OF JAN. 15, 1982)

A & G Transportation Co.
Aeron Marine Shipping Co.
Alaska Aggregate Corp.
Alaska Riverways, Inc.
Amak Towing Co., Inc.
American Atlantic Shipping, Inc.
American President Lines, Inc.
Ashland Alpha Shipping, Inc.
Ashland Oil, Inc.
Atlantic Marine Industries, Inc.
Atlas Marine Co.
Bankers Trust New York Corp.
Barge Bandon
Bethlehem Steel Corp.
Blue Lines, Inc.
Bultema Marine Transportation, Inc.
Cambridge Tankers
Campbell Towing Co.
Cement Transit Co.
Central Gulf Lines, Inc.
Citimarlease (Burmah I), Inc.
Citimarlease (Burmah LNG Carrier), Inc.
Citimarlease (Burmah Liquegas), Inc.
Citimarlease (Fulton), Inc.
Citimarlease (Whitney), Inc.
The Cleveland-Cliffs Iron Co.
Cook Inlet Tug & Barge Co. Inc.
Cove Maritime Companies, Inc.
CSI Hydrostatic Testers, Inc.
Crowley Maritime Corp.
Delta Steamship Lines, Inc.
Dillingham Tug & Barge Corp.
Durocher Dock & Dredge
El Paso Arzew Tanker Co.
El Paso Howard Boyd Tanker Co.
El Paso Southern Tanker Co.
Exxon Corp.
Farrell Lines Inc.
Ford Motor Co.
Foss Alaska Line, Inc.
Foss Launch and Tug Co.
Fred Devine Diving & Salvage, Inc.
GATX Corp.
General Electric Credit and Leasing Corp.
General Electric Credit Corp. of Delaware
General Electric Credit Corp. of Georgia
Gilco Supply Boats Inc.
Graham Boats
The Great Lakes Towing Co.
Hannah Bros.
Hannah Marine Corp.
Houston Natural Gas Corp.
Hvide Shipping, Inc.
Inland Steel Co.
Inter-Cities Navigation Corp.
Intercontinental Bulktank Corp.
Interstate Marine Transport Co.
Interstate Towing Co.
ITC Towing Co.
John E. Graham & Sons
L & L Marines
Luedtke Engineering Co.
Lykes Bros. Steamship Co., Inc.
Madeline Island Ferry Line, Inc.
Marine Leasing Corp.
Matson Navigation Co.
Middle Rock, Inc.
Monticello Tanker Co.
Montpellier Tanker Co.
Moore McCormack Resources, Inc.
Mount Vernon Tanker Co.
Mount Washington Tanker Co.
National Marine Services, Inc.
Neuman Boat Line, Inc.
O.L. Schmidt Barge Lines, Inc.
Offshore Marine, Inc.

Ogden Corp.
Oglebay Norton Co.
Ohio Barge Line, Inc.
Overseas Bulktank Corp.
Pacific Shipping, Inc.
Petro-Boats, Inc.
Prince William Navigation Co.
Prudential Lines, Inc.
Reynolds Leasing Corp.
Ritchie Transportation Co.
River & Gulf Transportation Co.
S & E Shipping Corp.
Sea Savage, Inc.
Seabulk Tankers, Ltd.
Smith Lighterage
Sun Company, Inc.
Tidewater, Inc.
Transway International Corp.
Tug Alaska Mariner, Inc.
Union Oil Company of California
United States Cruises, Inc.
United States Lines, Inc.
United States Steel Corp.
Warrior & Gulf Navigation Co.
Waterman Steamship Co.
Western Pioneer, Inc.
Windjammer Cruises, Inc.
Worth Oil Transport Co.
Young Brothers, Ltd.
Zidell, Inc.

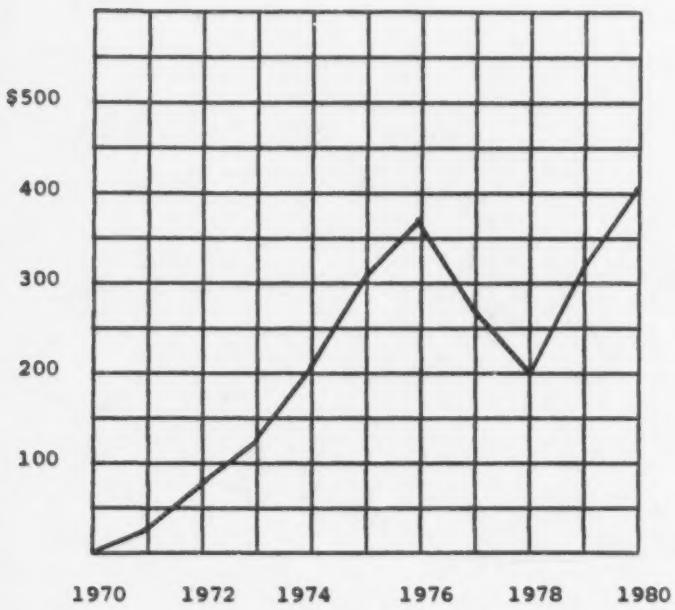
TABLE 3.—CONSTRUCTION RESERVE FUNDHOLDERS

(As of Mar. 19, 1982)

Cargo Carriers, Inc.
Central Gulf Steamship Co.
Gulf Mississippi Marine Corp.
Ingram Industries
Joan Turecamo, Inc.
Keystone Tankship Corp.
Lee-Vac Ltd.
Mobil Oil Corp.
National Marine Service
Port Arthur Towing Co.

Table 4.

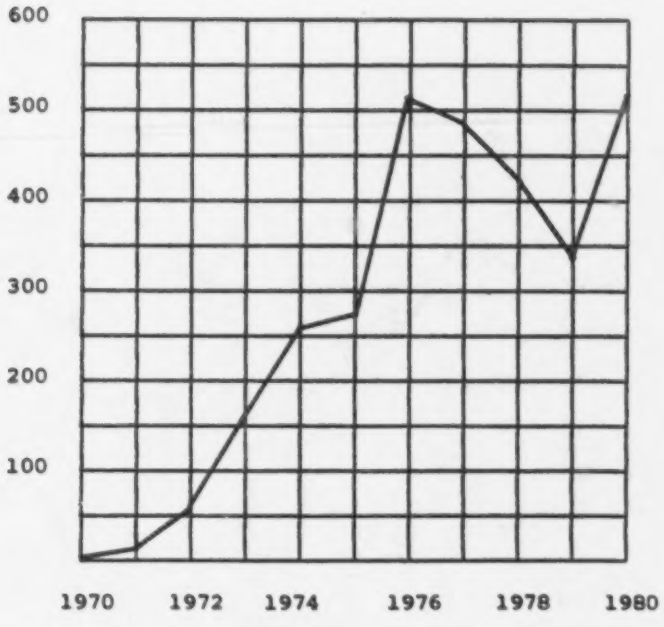
MARITIME ADMINISTRATION CCF
ANNUAL CONTRIBUTIONS
(millions of dollars)



Source: Maritime Administration, "Capital Construction Fund (CCF) Program Statistics Update for 1980" (unpublished)

Table 5.

MARITIME ADMINISTRATION CCF
FUND BALANCES
(millions of dollars)



Source: Maritime Administration, "Capital Construction Fund (CCF) Program Statistics Update for 1980" (unpublished)

TABLE 6.—MARITIME ADMINISTRATION CCF WITHDRAWALS

[In millions of dollars]

Year	Construct	Reconstruct	Acquired	Payment of existing debt	Total
1970 and 1971	$2.5	$1.5	$0.9	$2.7	$7.6
1972	5.4	6.4	4.9	16.9	33.6
1973	11.1	5.4	8.5	3.5	28.5
1974	47.2	25.4	24.9	3.5	101.0
1975	114.0	36.0	4.8	37.5	192.3
1976	162.7	6.1	31.2	43.8	243.8
1977	192.1	27.1	32.8	34.4	286.4
1978	188.3	20.1	27.5	27.9	263.8
1979	263.6	26.0	106.9	12.5	409.0
1980	53.6	51.9	78.4	71.6	255.5
Total	1,040.5	205.9	320.8	254.3	1,821.5

Source: Maritime Administration, "Capital Construction Fund (CCF) Program Statistics Update for 1980" (unpublished).

TABLE 7.—REVENUES FROM PROPOSED MINIMUM TAX ON CCF's

	1983	1984	1985	1986	1987
Total minimum tax revenue (in millions)	$2,300	$4,800	$4,500	$3,700	$3,800
CCF minimum tax revenue (in millions)	$28	$26	$16	$13	$11
CCF as percent of total	1.2	0.5	0.4	0.4	0.3

Sources: Joint Committee on Taxation and Department of the Treasury estimates. Minimum tax revenues calculated as 15/46 of estimated cost of CCF. Percentage figures will actually be lower because of $50,000 exclusion in minimum tax.

Chairman ROSTENKOWSKI. Without objection the statements of all the witnesses will be included in the record in full.

Gentleman, put yourself in our position. We sit here listening to witnesses refuse to suggest that we tax them or their industry. There is no question that revenues must be raised.

Mr. Perlman, why don't you lead off. Tell us how to do it. Tell us where your industry would be willing to make the sacrifice that is needed.

Mr. PERLMAN. Believe it or not, I anticipated the question.

One area that the high-technology companies are perfectly willing to see some tightening up and modifications made is in the area of the safe harbor leasing and in the sale of investment credits between corporations.

Another area is some modifications in the ACRS depreciation methods which really have not helped us nor reflected the reality of our industry. I can offer several suggestions in the ACRS area. One would be to reextend, if you will, the life of buildings from 15 to 20 to 25 years. A second would be to slow down the time when ACRS deductions are increased by double declining balance depreciation and leave the present rules at 150 percent declining balance for a while. And a third suggestion might be to take the R. & D. equipment that is presently in the 3-year category under ACRS and put it in the 5-year category. There is really not much difference in our industry between the research and development equipment and in one particular instance the fabrication equipment. These are areas, knowing you must raise revenue in some way, we

think would be acceptable and most of our companies would be able to live with.

Mr. CONABLE. Would these have a major impact on your industry?

Mr. PERLMAN. Yes, sir, absolutely.

Chairman ROSTENKOWSKI. Mr. Berman, what do you think?

Mr. BERMAN. Mr. Perlman's list includes the ideas that we discussed together, and it is a list of things that I think are important.

I think absolutely that revenue has to be raised. At the same time, I would feel very badly if we destroyed some of the good things we have started as a result of last year's Tax Act. I think it would be particularly unfortunate if the R. & D. credit were changed, especially since both the AEA and MHTC are working very hard on a program to get each and every company to devote 2 percent of their R. & D. budgets to an aid for universities in producing larger quantities of engineering computer science graduates. This is a lot of money. It is helped by the legislation enacted last year.

I think the incentive stock options are also important. It is one of those elegantly beautiful things that happens from time to time. It increases the revenue and makes some sense to the people who use them and the companies, particularly those 80 percent of our companies that are very small, which can use the options to get the use of superior technical and business people into their companies.

I think there is no question that the one industry that has produced the most exciting growth in this past year has been electronics, semiconductors, the kind of businesses we are in. These are things that are very important to us.

Sure, raise the level of taxes in general, but changing all these little incentives is, in the long run, much more damaging. If you need some money, raise the rates.

Chairman ROSTENKOWSKI. Mr. Cherecwich, would you like to make a comment?

Mr. CHERECWICH. Yes, sir; it would be fairly easy for me to say in our industry to get rid of the sale of tax credits. Not too many companies that I have heard of in our industry are engaged in safe harbor leasing. That is because the high-technology companies do not tend to be particularly capital intensive. We spend a lot of capital on R. & D., but we don't buy a lot of capital assets.

What would affect our industry would be to stretch out the 15-year building depreciation to 20 or 25 years because the high-technology industries are expanding. We do need buildings. That would affect us and I think that is something that would be appropriate.

The 5-year asset ACRS acceleration that is supposed to come in a few years, the 200-percent declining balance portion could be postponed for a few years and that would have an impact on us also.

Finally, what would have a big impact certainly on my company, which is currently profitable, would be a temporary corporate surcharge or raise in the corporate tax rate of 1 or 2 points for 2 years. It is far easier to turn around and cut back on a corporate tax rate after the economy turns around than it is to unwind some very complex corporate minimum tax provisions or to go into all of the inventory accounting rules and try to straighten things out in

that area if we jump too hastily by passing the administration proposals.

Mr. BERMAN. Absolutely.

Mr. BLACK. Unlike the other members of the panel, the Council on American-Flag Ship Operators is opposed to the erosion of incentives for investment in productive capacity that were included in the 1981 act, but we do recognize that there may be a need for additional revenues, and if that is the case, there may be appropriate short-term changes to make in the corporate rates or maybe ways to defer some of the individual rate reductions in the 1981 act.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Mr. Chairman, I thought you asked an interesting question and I think the gentleman responded in a positive manner. At least you did make some recommendations where we could raise additional taxes, but if it would affect your own business to some extent, at least, I think you are being responsible.

It does concern me, as we have said in hearings, that the President has recommended nine different areas that would provide for tax increases or for increased revenues through tax collections, and no one has expressed much about any of them.

I am going to list them for you.

Completed contract method of accounting; energy tax credits for business; tax-exempt revenue bonds for private activities; modified coinsurance; construction period interest and taxes; corporate minimum tax; accelerated corporate tax payments; increasing the IRS staff; and withholding of interest and dividends. These are the nine recommendations.

I know you have come clearly opposed to the completed contract accounting, tax-exempt bonds proposals and the minimum corporate tax measure.

Do you support any of the rest or would you rather take the approach that you have outlined to Mr. Rostenkowski?

Mr. CHERECWICH. Sir, I think the speedup in corporate tax collections is probably appropriate. It gives me a minor administrative problem in trying to predict very accurately and in a timely fashion what those profits will be as the numbers require us to get closer and closer to 100 percent accuracy, but I think that we could do that.

In terms of the withholding on interest and dividend payments, I don't think that it is appropriate for me to comment because that does not directly affect my company.

Mr. PICKLE. I can understand that.

We would be glad to receive any testimony from you.

Mr. PERLMAN. If I may for a moment.

Mr. PICKLE. I thought it interesting you would be willing to raise the corporate tax. We may accept your recommendation.

Mr. CHERECWICH. I should point out I am not speaking for my trade association because I haven't discussed that with them, but thinking about the simplicities of administration and the ability to repeal any increase in corporate taxes when the economy turns around, I think that that is very important. You also avoid the distortions and you give a chance for the provisions that were in ERTA to work the way they were intended to work.

Mr. PICKLE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. I have no questions, Mr. Chairman.

I do think it has been a very interesting discussion. I appreciate your suggestions.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman.

I want to thank the panel for the forthright presentations and the plugs for my bill and Mr. Shannon's bill, which obviously were designed to help the industry and I am proud to do that. But a couple of questions.

DISC was mentioned. I have always felt that DISC really does nothing more than provide a tax break to an export transaction that would take place anyway. It has been viewed by our GATT partners as an illegal subsidy, which indeed it probably is.

We keep saying that we are going to remove it only when we can get something back.

Would you all agree that DISC really doesn't stimulate or create any new exports, it merely is an extra bonus to somebody who would export anyway?

Mr. PERLMAN. If I may, sir, I think that is the conclusion that many casual observers could come away with. However, since DISC is, and I will admit it, indirect export subsidy, I think it would be foolish to look at it in any way. DISC does enable us to lower our prices to overseas customers and thereby obtain what in our industry could otherwise become some very marginal business that might otherwise not be profitable. In that sense, I think, sir, DISC does stimulate increased exports.

Mr. BERMAN. It goes directly to employment of Americans to build that equipment.

Mr. STARK. If we could all have our druthers, let's say for a minute we take away DISC and drop the corporate marginal rate a point or two, on your overall corporate rate, just take whatever the revenue loss of DISC is and apply it to a lower corporate rate. Would you prefer that?

Mr. BERMAN. That is specifically why we would rather have a corporate rate temporary increase than modifying other things, including DISC. It is complicated enough already. We spend millions, each company, or each association certainly, millions in just keeping track of these things and handling them right. You could make any tax increase less complicated, make it easier for us to do business by doing something general like changing the corporate tax rate. That is a hell of a lot simpler, a lot easier, and it makes it easier for us to do business and employ people.

Mr. CHERECWICH. If I may disagree with my colleague on that point. I think DISC has been a very, very valuable incentive and I refer to it as an incentive. I know many small companies that were not previously exporting who are now exporting. I know the experience in my own company when we began to talk about the DISC. It has resulted in many, many people becoming sensitized to the value of exports to our total business and to our economy. As to the question that the DISC rewards companies that would export anyway, I just note that in 1976 that issue was corrected when the Congress passed the rolling base period so DISC benefits are only

available for increases in exports over the base period. I also wonder why our friends in France, and Belgium, and the Netherlands are so upset about DISC if it isn't helping to create exports that wouldn't otherwise be there.

Mr. BERMAN. I don't disagree with you.

Mr. PERLMAN. We all agree on that, Mr. Stark.

Mr. STARK. There is a question under the regulations which allocate your R. & D. credit, 1.861-8, and people have said that that may have caused firms to relocate their R. & D. outside the United States. Do any of you know of any instances where a high technology firm has actually done that?

Mr. PERLMAN. I can refer to the reverse of that question. Since the moratorium was put on in ERTA for 2 years, in my own company we have readdressed the issue, because we have research and design facilities offshore. The moratorium has clearly affected our decision to increase the research in the United States and not to beef up the facilities offshore.

Mr. CHERECWICH. Mr. Stark, 2 years ago my company addressed a series of problems faced with R. & D. One was tax disincentives caused by 1.861-8 and the loss of foreign tax credits. The other was a lack of skilled engineers and our ability to attract them to Massachusetts. The combination of those two factors coupled with the infrastructure we already had available in the Netherlands and in the United Kingdom did in fact cause us to relocate R. & D. activities overseas.

We moved that activity in 1981, and we have spent $900,000 last year, and we expect that amount of money to increase rather dramatically in the next few years. We hope that the suspension of the 1.861.8 is made permanent so that we can bring those people back and do our business planning on a better basis.

Mr. STARK. I might suggest if you move your facility to California, particularly the Livermore Valley, that you might find engineers would be lining up to work at reduced rates in your institution. I was trained near Route 128, but I must say there is a certain parochial incentive to suggest that you would be welcome in our State.

Could I direct one quick question at the counsel for the flagship operators. It was suggested to me, by a Navy liaison personnel, that if I wanted to increase shipbuilding and ship repair in the bay area, that it was specifically being directed away from the bay area because the political climate was bad for the Navy. He may have referred indirectly to the protests of the seventies and the sixties, but, that the way for me to increase ship repair work in the bay area was to vote for the new nuclear carriers.

How would you react to something like that? Do you think building a nuclear carrier would have any effect on shipbuilding business and ship repair business in the San Francisco Bay area?

Mr. BLACK. I can't give a very specific answer to that, but as a general matter, I am sure that the increase in naval shipbuilding benefits the shipbuilding and ship repair industry as a whole, and to the extent that building a nuclear carrier on the east coast means that that yard capacity is more used up, certainly has to put extra demand on other yards elsewhere, hopefully in the bay area.

Mr. STARK. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Gephardt will inquire.

Mr. GEPHARDT. One quick question. Mr. Perlman, in your testimony you talk about the Japanese success with the new memory market and you say that 70 percent of the 64K RAM market is now claimed by them. You say all the technical papers at the last meeting on 256K were done by them. Does this mean that we are going to get shut out in the future in this industry or are we going to compete?

Mr. PERLMAN. It absolutely does not mean we are going to be shut out. I think what it does mean is that we are facing a new threat from the Japanese and that is a technology, rather than a production and manufacturing threat and it is a threat that we must respond to.

As I am sure you are aware, the Japanese Government will select a particular type of product and they will focus their entire energies on that item with the full cooperation of the Government and the financial infrastructure of the country.

We have to dance to a different drum, if you will, over here, and, therefore, if you will relate the rest of my testimony to that example, you will find that all we are asking is that Congress not make it any more difficult for us to compete than it already is.

My company—I just saw a figure last week—in the past 3 years, spent $750-some odd million, three-quarters of a billion dollars, on research and development and plant construction. That is equal to our 1981 revenues. We spent over 300 percent of our after-tax profits of 1981 on research and development.

The R. & D. credit and other provisions mean an awful lot to us. It will definitely hurt our ability to compete with that type of a focused threat from the Japanese, if U.S. tax provisions are tightened up and becomes more expensive for us to operate in the United States.

Mr. GEPHARDT. Thank you very much.

Mr. PERLMAN. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Vander Jagt will inquire.

Mr. VANDER JAGT. Thank you. I would like to thank the panel participants for a most interesting discussion. I would like also to have your comments on how helpful the tax incentive in last year's Tax Act for research and development have proven to be; further, how helpful you think they will be in the future and whether it is important to give some permanency to those R. & D. incentives. Like Mr. Stark, I wish to thank you for supporting the concepts in my legislation designed to do that.

Mr. CHERECWICH. Mr. Vander Jagt, shortly after the passage of ERTA, SAMA took a survey of its members to determine whether or not ERTA was going to have any impact on their activities. And the results of that survey showed that 86 percent of the respondents planned to increase their R. & D. expenditures, more than half of them in 1982. The levels of increase were kind of interesting. Some 66 percent said that their levels of increase would be between 5 and 15 percent of their previously planned R. & D. expenditure levels.

One thing that did concern me a little bit, however, was the indication that most of this increase was going to go into an applied area and not very much into the basic research area, and one of

the reasons that I think may have something to do with that has to do with the omission in ERTA as finally passed of the provision in the bill that this committee put out last year regarding university R. & D. expenditures and its elimination from the rolling base period.

I would suggest that maybe that is one of the areas that needs some fixing up to achieve the original objectives.

Mr. VANDER JAGT. Thank you very much.

Mr. BERMAN. I think it would be interesting, sir, to note that the electronics business, including the semiconductor business, is one which is continually increasing and must continually increase its R. & D. expenditures. It lives on it.

All of the 1,900-odd companies in our association depend on R. & D. and increasing R. & D. year after year after year. The whole reason that this industry has grown so fast is the development of all these nifty goodies.

The R. & D. tax credit has been extremely useful and will continue to be so. It is very important to these companies if you would like a direct answer to the question.

Mr. VANDER JAGT. Thank you very much.

Chairman ROSTENKOWSKI. Thank you, gentlemen. You have been very helpful.

Our next witnesses are Mr. Nolan, Mr. Bushman, and Mr. Schneider.

Welcome gentlemen. Nice to see you back again. If you will identify yourself, John, and proceed with your testimony, the committee is ready to receive it.

STATEMENT OF JOHN S. NOLAN, COUNSEL, AEROSPACE INDUSTRIES ASSOCIATION

Mr. NOLAN. Thank you very much, Mr. Chairman.

My name is John S. Nolan, I have 35 years of experience in tax practice in the accounting and legal professions, including particularly tax accounting methods.

I appear today for the Aerospace Industries Association in strong opposition to the Treasury Department proposals, both in regulations and proposed legislation, with respect to the completed contract method. I submit a detailed statement for the record which sets forth the need for the completed contract method, particularly in the aerospace industry; the serious adverse effect that denial of this method would have on our national defense; and the fundamental objections that arise as to the Treasury Department's proposed new progress payment method of tax accounting.

The Treasury proposals actually go well beyond an effort to repeal the completed contract method of tax accounting. They seek to impose an ill-conceived, radical new tax accounting method on the construction, shipbuilding, heavy equipment, and aerospace industries, whether or not the particular company involved has been using the completed contract method. They seek to deny to these industries the traditional use of the accrual method of accounting available to all other business taxpayers. They seek to tax cashflow rather than income, a drastic concept which would reject all

accounting principles and raise serious constitutional questions under the 16th amendment.

These proposals will create extraordinary new inequities, complexities, uncertainties, litigation, and administrative difficulties in the income tax system for business taxpayers. This is completely unnecessary, and the Treasury proposals should be rejected by this committee. The Treasury Department should be immediately instructed not to issue any proposed regulations until the matter has been studied by this committee. Treasury should ultimately be instructed to revise the regulations to eliminate any undue benefits in the completed contract method but to preserve its existence. Treasury should be advised to amend the regulations to achieve greater consistency with the regulations governing accrual basis taxpayers with inventories. The Aerospace Industries Association has suggested a number of constructive changes to the Treasury Department and is prepared to cooperate further in improving the regulations. This process will result in some significant revenue gains for the Federal Government and will also result in greater equity, simplification, and ease of administration of the tax laws for all business taxpayers.

Mr. Chairman, the committee asked the prior panel what that particular industry was willing to do with respect to increasing taxes on such industry. The Aerospace Industries Association in January of this year, before the Treasury Department made its completed contract proposals, submitted a comprehensive analysis of the completed contract method to the Treasury Department and made a number of specific suggestions for changes in that method which would increase taxes on this industry. When the Treasury Department issued its proposals in February 1982, some of our suggestions were included in such proposals, but unfortunately, Treasury went well beyond the suggestions we had made and would impose a radical new tax accounting method which simply will not work.

Everyone is deeply concerned about the complexity and the inequities in our tax system. The Treasury Department, in a desperate effort to propose new revenue enhancers has jumped upon the defense industry and a few others which are politically vulnerable to propose massive new tax burdens on those industries in the ever-popular name of closing loopholes or tax reform. The Treasury proposals are not well thought through and would do serious structural damage to the tax system.

The progress payment method of accounting will create enormous new complexities both for large and small business and will cause serious new inequities. Treasury seeks also to increase the tax burden on the aerospace industry still further through the corporate minimum tax proposals. Treasury would impose this minimum tax with respect to contracts entered into by the industry in prior years. This would impose a substantial, added financial cost on the defense and construction industries.

These multiple financial burdens that the Treasury proposals focus upon the aerospace industry could do major harm to our national defense. This industry is already earning an average of only 3.8 percent on sales with the benefits of the completed contract

method. It cannot afford the crippling financial burden that would result from withdrawal of the method.

The Treasury proposals could easily raise the cost of national defense more than they would produce in added tax revenues, and in the process they would seriously disrupt the capital planning of this vital industry. This makes no sense whatsoever at a time when we are seeking to induce our major industries to modernize and expand their facilities.

The Congress is deeply concerned about projected triple-digit deficits over the next 3 years, but this cannot justify adoption of an ill-conceived new tax burden on the construction and aerospace industries. This is particularly so when the change would do serious harm to the structural integrity of the tax system, would cause severe new complexities and inequities, and would do serious damage to our national defense.

I strongly urge you to reject the Treasury proposals and proceed as I have suggested.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN ON BEHALF OF THE AEROSPACE INDUSTRIES ASSOCIATION

COMPLETED CONTRACT METHOD

My name is John S. Nolan. I have thirty-five years of experience in tax practice in the accounting and legal professions, including particular tax accounting methods.

I appear today for the Aerospace Industries Association in strong opposition to the Administration's proposals with respect to the completed contract method. These proposals actually go well beyond an effort to repeal the completed contract method; they seek, in effect, to impose an ill-conceived, radical new tax accounting method upon all businesses delivering products to the customer's specifications under contracts extending over more than one year. This new method, which the Treasury calls the "progress payment method", will cause extreme hardship to the construction, shipbuilding, heavy machinery, and aerospace industries. The proposal would create enormous uncertainty as to the tax reporting of these industries; result in extraordinary, new complexity in the tax laws; cause severe tax administration difficulties for the Internal Revenue Service; and produce major inequities in the treatment of similarly-situated business taxpayers.

The Administration's proposal should be rejected by this Committee. The Committee should direct the Treasury Department to reconsider the regulations dealing with "long-term contracts" and improve their application in light of experience gained over the last ten years. The Aerospace Industries Association has suggested a number of specific improvements to the Treasury Department in written and oral communications over the last several months. The Treasury Department should be immediately advised not to publish any proposed regulations until the issues involved have been considered by this Committee. Following such consideration, the Treasury Department should be clearly instructed to preserve the completed method but to revise the regulations to eliminate any undue benefits but in a manner entirely consistent with the regulations governing accrual basis taxpayers maintaining inventories. This consistency will result in much greater equity, simplicity, and ease of administration among business taxpayers. In the process, it will result in some significant revenue gains for the Federal Government.

The following analysis sets forth—(a) the reasons for use of the completed contract method, particularly in the aerospace industry with its unique profit or loss uncertainties and tax reporting difficulties; (b) the extraordinary, adverse impact that denial of this tax accounting method would have upon our national defense; and (c) the fundamental fallacies in the Treasury's proposed new "progress payments" tax accounting method and the severe inequities, uncertainties, and complexities it would create.

I. SUMMARY

The completed contract method of tax accounting is predominantly used for federal income tax purposes in the construction, shipbuilding, and aerospace industries. This occurs because in these particular industries, there are extraordinary uncertainties as to profit or loss, which are determinable only as contracts are completed. Further, there is no other reasonable method of tax accounting for determinig taxable income in these industries; any other existing method requires the use of uncertain estimates of receipts and costs.

Use of the completed contract method was extended to manufacturing businesses with contracts extending over more than one year in regulations proposed in 1971. This extension was the result of consultations by several industries, including the aerospace industry, with the Internal Revenue Service, the Treasury Department, and the Staff of the Joint Committee on Taxation. The conclusion of the Internal Revenue Service and the Treasury Department in 1971 to clarify the use of the completed contract method took into account the extensive litigation that had occurred as to proper tax accounting methods for industries such as aerospace, shipbuilding, nuclear plant construction, and commercial construction. Some companies in these industries had been permitted to use the completed contract method; some had not. Those using the completed contract method were not experiencing the difficulties of those not using it. Some companies had sought to deduct losses in the early stages of long-term contracts; others, using the completed contract method, could not do so. The objective of the changes reflected in proposed regulations in 1971 was to resolve the resulting uncertainties on a balanced basis that protected the interests of both the Government and these industries.

As a result of these actions, virtually all members of the aerospace industry sought and received permission on an individual basis from the Internal Revenue Service to use the completed contract method. Various conditions were imposed by IRS to safeguard its interests, such as limiting the use of carrybacks, and these conditions were accepted by the industry.

The method has now been used by most members of the industry for periods from five to ten years. The resulting deferral of tax liability in the industry, and consequent effect upon its cash position, has been taken into account in determining acceptable profit rates and progress payment needs in its contracts, and thus in the pricing and negotiation of contract terms for the great majority of the industry's products. A withdrawal or substantial curtailment of the existing use of the method would seriously cripple this industry's capacity to provide for the critical defense needs of the United States.

The short-term revenue gain to the Treasury Department from withdrawal or substantial curtailment of the use of the completed contract method by the aerospace industry would be significantly limited by the effect of essential transition rules. The Treasury's proposed transition rules are unfair because they would treat the transitional adjustment, in effect, as a tax preference for purposes of their proposed new corporate minimum tax. This would substantially reduce the transitional relief.

The long-term gain of the Treasury's proposals would be extremely uncertain because of the unique tax accounting difficulties in this industry. There would be little revenue effect in the 1983–1985 budget period.

It is unfortunately more likely that there would be a return to the uncertainly which formerly existed and the litigation which prevailed. The same is probably also true in the case of the construction, shipbuilding, and other industries using the completed contract method of accounting where there is a high degree of uncertainty as to the realization of profit or loss until particular contracts are completed.

The Treasury Department seeks to avoid these uncertainties by proposing the required application of a new tax accounting method first described by them on February 26, 1982. This method, the "process payment method", has no antecedent in the seventy years of history of our income tax system and would be completely rejected by the accounting profession. It has startling attributes which even raise Constitutional questions—such as attempting to tax borrowed funds as income, denying the taxpayer the right to offset losses on some contracts within a single business against profits on other contracts in the same year, and denying the taxpayer the right to offset a loss on a contract in a later year of its performance against profits erroneously required to be reported on that some contract in an earlier year.

In addition, the Treasury would require this new progress payment method to be used for long-term contracts whether or not the taxpayer would otherwise have used the completed contract method. Thus, Treasury seeks to deny to all businesses with long-term contracts the use of the traditional accrual method of accounting and to

impose harsh, new cost allocation rules on these businesses which are completely unworkable and inequitable. This proposal must be rejected; it will cause unprecedented uncertainty for business taxpayers and result in endless litigation. Businesses will be forced to attempt to revise their ordinary business practices so that their contracts are not "long-term contracts" so that they can obtain the same tax treatment as all other business. Small businesses will be faced with an entirely new set of extremely complex tax problems.

This major change in the tax accounting treatment of business taxpayers is unnecessary. There are some problems in the use of the completed contract method for tax purposes; ten years' experience with the substantial changes in the regulations proposed in 1971 have brought these problems to light, as would be the case in any such important change in regulations. The Aerospace Industries Association itself has brought many of these problems to the attention of the Treasury Department over the last several months and has made constructive suggestions for specific improvements. Many of these changes will result in significant revenue increases. Most importantly, however, any changes in the regulations must treat all business taxpayers evenhandedly. Businesses with long-term contracts cannot be more harshly treated than accrual basis taxpayers with inventories of goods not manufactured to the buyer's specifications—i.e., shelf items, such as steel shapes, automobiles, television sets, or any standard manufactured products, whether producer goods or consumer goods.

II. THE COMPLETED CONTRACT METHOD

A. Historical background.—The completed contract method of tax accounting has been sanctioned by Treasury Regulations since 1918.[1] In subsequent years, substantial controversy developed over the use of estimates in determining income and in the treatment of advance or progress payments for goods to be delivered in the future, issues which particularly affected the construction, shipbuilding, and aerospace industries.[2] The possibility of large losses on long-term contracts by manufacturers using the accrual method of tax accounting led these manufacturers to seek loss deductions under the lower-of-cost-or-market inventory convention available to accrual basis taxpayers, and the courts allowed these losses.[3]

Many controversies also developed between the IRS and the aerospace industry as to the use of the accrual method. For financial accounting purposes, the industry to a substantial degree averaged its cost of sales upon deliveries over the entire number of units under a defense contract, or commercial airplanes under a "program" to build a given model. This reflected the fact that the construction of the initial airplanes, missiles, or space vehicles results in a much higher unit cost than subsequent units. Direct labor costs in this highly labor-intensive industry reflect the intricate fabrication and assembly of hundreds of thousands of individual parts or pieces for any unit. These direct labor costs follow a "learning curve" as production proceeds from one unit to the next under the contract or program. Material costs reflecting spoilage, and tooling costs to some extent, follow the same pattern. The product is priced under the defense contract or commercial airplane program on a unit basis which reflects an averaging of these major costs, and financial accounting often follows the same concepts to determine profits or losses as units are delivered.

For tax purposes, however, the initial high level of costs of units delivered could be deducted on the accrual basis as deliveries of these initial units occurred. The costs had been actually incurred. At the same time, these abnormally high costs, which would result in large losses if deducted, would normally be recovered in the price of units to be subsequently delivered under existing contracts. Some companies deducted the high costs attributable to the initial units as they were delivered. Other companies followed their financial accounting treatment and averaged their costs over their defense contracts or commercial airplane program on a contract-by-contract or program-by-program basis. This averaging, however, necessarily involved

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[1] Reg. 121, § 33. The courts upheld the application of these regulations in early cases such as *Badgley* v. *Commissioner*, 59 F. 2d 203 (2d Cir. 1932), and *James C. Ellis*, 16 BTA 1225 (1929).

[2] See Schneider, *Tax Accounting for Contractors: Planning Under the New Regulations*, 35 N.Y.U. Ann. Inst. 29, 31–36 (1977).

[3] *Space Controls, Inc.* v. *C.I.R.*, 322 F. 2d 144 (5th Cir. 1963) rev'g and rem'g 21 TCM 295 (1962); *E. W. Bliss Company* v. *United States*, 351 F. 2d 449 (6th Cir. 1965). See also *St. James Sugar Coop, Inc.* v. *U.S.*, 643 F. 2d 1219 (5th Cir. 1981). In *Rockwell International Corp.* v. *Commissioner*, 77 T.C.—, No. 57 (Oct. 13, 1981), the Tax Court denied such an inventory write-down for the taxpayer's fiscal year ending September 30, 1969. The taxpayer is expected to appeal to the Third Circuit.

the estimation of future costs of production under the contract or program in determining the costs to be deducted on the delivery of the early units.

The Internal Revenue Service was unhappy with either alternative—one involved the deduction of losses that could be said to be unrealistic, and the other involved the extensive use of "estimates"—which is anathema to the IRS. As a result, much controversy existed in the 1950–1971 period.

In 1970, the President's Task Force on Business Taxation addressed itself among other issues to areas of controversy such as this one and strongly recommended new initiatives in regulations to reduce the resulting uncertainties in business taxation.[4] The completed contract regulations were one of these initiatives. They followed perhaps the most intensive debate and analysis between the Treasury Department and the Internal Revenue Service of any of the regulation projects at that time. Among other objectives, they were deliberately designed to offer a reasonable alternative to the aerospace industry to resolve its unique tax accounting problems, while still protecting the interests of the Government by requiring capitalization and deferral of the deduction of costs until completion of the contract, thus denying the deduction "up-front" of substantial but perhaps unrealistic losses.

B. Development of the regulations.—The first proposed regulations contained a financial conformity requirement. This necessarily would have insured that costs could not be deducted for tax purposes before they were treated as cost-of-sales or expenses for financial accounting purposes.[5] The conformity requirement would have dramatically restricted the availability of the completed contract method to all of the affected industries. It was severely protested by the construction industry and its Congressional representatives. It was thereupon abandoned.

The revised proposed regulations issued December 15, 1971,[6] eliminated the financial conformity requirement but required complete consistency in the treatment of indirect costs with the full-absorption inventory regulations. Under the latter regulations, some indirect costs must be capitalized as inventory costs in all events, some must be deducted as period costs in all events, and some must be treated either as inventory costs or as period costs depending upon their treatment for financial accounting purposes.

In the final long-term contract regulations issued on January 14, 1976, this latter treatment of costs was eliminated. Instead, the Treasury Department undertook to specify the treatment of all costs either as costs of the contract, to be deferred until contract completion, or as period costs, in accordance with then-existing precedents in court cases and published rulings.

The final completed contract regulations provide that the current service portion of pension costs and certain other employee benefit costs need not be treated as costs of the contract, but rather are to be treated as period costs.[7] This directly parallels the treatment of such costs with respect to self-constructed property. In I.T. 3408,[8] a ruling still in effect, the IRS determined that pension costs for construction workers are a period cost. When it proceeded to litigate the capitalization of depreciation with respect to self-constructed property in the Supreme Court in the *Idaho Power Co.* case, it specifically conceded the deductibility of pension costs, reflecting a widespread belief in the IRS that there is no authority to require any capitalization of qualified plan pension costs inasmuch as their deduction is provided for specifically in Code § 404.[9]

The treatment of pension costs as a period cost in the long-term contract regulations is also consistent with their treatment in the full-absorption inventory regulations with respect to accrual basis taxpayers that employ a non-conforming method of accounting for financial reporting purposes.[10]

The relationship of the treatment of costs for inventory purposes under the accrual method and in the completed contract method is self-evident. Under the accrual method, income is accrued as deliveries of units occur and thus as the contractor is deemed to earn a specified portion of the contract price for the units delivered. Costs of manufacturing the units, including allocable indirect manufacturing costs,

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[4] *Report of President's Task Force on Business Taxation*, Sept., 1970, p. 60.

[5] Prop. Reg. § 1.451-3 (March 24, 1971).

[6] Prop. Reg. § 1.451-3 (December 15, 1971).

[7] Reg. § 1.451-3(d)(5)(iii)(*b*). Compare Reg. § 1.471-11(c)(2)(iii)(*c*) and (ii)(*b*).

[8] 1940-2 C.B. 178.

[9] *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974). In 1978, the Internal Revenue Service commenced a regulations project, EE 56-78, to require capitalization of § 404 costs with respect to self-constructed assets. The project has never been completed, possibly because of uncertainty as to the validity of the rule it would propose. See *All-Steel Equipment Inc.*, 54 T.C. 1749, 1766 (1970); I.T. 3408, supra, footnote 8.

[10] Reg. § 1.471-11(c)(3)(ii)(*b*).

must be capitalized as inventory costs and deducted as cost-of-sales as the units are delivered. Under the completed contract method, income is not accrued until the entire contract or program is completed, and costs of manufacturing the units (including certain allocable indirect manufacturing costs) must be capitalized and deferred until such completion. Losses may not be recorded under the completed contract method until the contract is completed; there are no exceptions to this rule. Under the accrual method, losses may be recorded by virtue of the cost-of-market inventory convention, to the extent of costs incurred, prior to the time that it is known whether or not losses will actually be sustained.

From the standpoint of tax policy, it is equally important to insure both that—(1) losses are not recorded before they are actually sustained (except pursuant to the cost-or-market inventory convention); and (2) income is recorded at the time that it is actually earned. The accrual method as applied in the *Space Controls* and *E. W. Bliss* cases permits losses to be reflected based on estimates of future performance; the completed contract method, while not permitting the recording of losses, must be applied so as to insure that the contractor reports profits when there is sufficient certainty that they have been earned, but not before that time.

III. THE COMPLETED CONTRACT METHOD IS ESSENTIAL FOR PROPER TAX ACCOUNTING FOR THE AEROSPACE INDUSTRY

A. The risks and uncertainties of the industry.—The conceptual basis of the completed contract method was accurately stated by the IRS in 1970: One of the reasons why permission to report on a completed contract basis is given in the case of building, installation and constrution contracts, is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay and unexpected difficulties in laying foundations which make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed.[11]

These uncertainties, both as to price and to cost, exist to a much greater degree in the aerospace industry. Major technological break-throughs continue to occur during the development and production of any major weapons system, requiring extensive engineering changes to units already produced and yet to be produced, with resulting major uncertainties as to costs and prices for the product. These are technological changes not known at the time the contract was entered into. In fact, it is unique to the aerospace industry that it enters into combined development-production contracts of long duration calling for the contractor to invent and develop new products.

The result of these conditions is that in the performance of any major defense or commercial contract by the aerospace industry, there are very frequent technological advances, often overlapping and replacing one another, with major effects on cost. The uncertainties of costs and prices in the aerospace industry have very little, if any, counterpart elsewhere in American industry. Thus, there is no other industry in which catastrophic losses on particular contracts or programs occur in the magnitude and with the frequency and unpredictability that they occur in the aerospace industry.

On the pricing side, the Defense Department and other agencies buying from aerospace companies utilize the most sophisticated price techniques imaginable. They include infinite varieties of contracts which are fixed price, fixed price with redetermination clauses, fixed price incentive contracts, cost plus incentive fee contracts, cost plus fixed fee contracts, cost plus award fee contracts, and others. The incentive provisions may be based on the variation in actual costs from target costs, with maximum price provisions so that the contractor at some point bears the risk of 100 percent of cost overruns; or upon performance incentives based upon specific achievements, such as speed, altitude, rate-of-climb, accuracy of missiles, or more complex objectives; or upon value engineering concepts; or upon combinations of all of the foregoing factors. Major defense contracts in the aerospace industry, both cost and fixed price type contracts, normally contain provisions for cost and performance incentives which make profit highly uncertain until the completion of the contract, when the effect of the incentive provisions is first fully known. Operation of the incentive formulas could result in a final profit substantially greater or less than originally anticipated and negotiated, or could even result in a net loss. In addition, such contracts normally contain a ceiling price, exposing the contractor further to substantial risk of loss.

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[11] Rev. Rul. 70-67, 1970-1 C.B. 117.

In addition to technological changes and incentive formulas, other regulatory and contractual provisions and procurement practices virtually assure that the profit or loss position of an aerospace contractor on a major defense contract cannot be ascertained with any reasonable degree of certainty until completion of the contract. The Government retains the right throughout contract performance to terminate the contract in whole or part for any reason. Such a termination can reduce very significantly the contractor's expected profit. Moreover, the Government frequently directs major changes to be made, but the contractor is required to proceed with the work as directed and to later negotiater the price for those changes. The difficulties in segregating the cost caused by such changes, quantifying the amount of increased or decreased cost resulting from the changes, and disagreements over allocation, allowability and reasonableness of cost incurred, can result in protracted negotiations and litigation with no assurance that the contractor will recover the full cost of such changes.

The Government is normally responsible for costs caused by defects in, or late delivery of, Government furnished equipment, drawings, and specifications. A contractor, however, can experience substantial delay, disruption, test, rework, and other costs before the problem might be identified as caused by the Government furnished equipment, drawings, and specifications and before the accounting procedures can be established to segregate such costs. A contractor's profit or loss position on a contract may vary significantly depending on the contractor's ability, on a retroactive basis, to identify and quantify such cost increases.

While the analysis in this statement tends to emphasize the uncertainties of prices and costs in defense contracting, these uncertainties exist to the same degree with respect to commercial business, including sales to domestic airlines and to foreign governments, foreign airlines, and others. These commercial sales are very substantial, and export sales are a large portion of total U.S. exports. The uncertainties are increased by intense competition both within and without the United States by foreign aerospace companies, often supported in varying degrees by their respective governments. The European airbus, for example, represents severe competition for U.S. aerospace products in sales to U.S. airlines.

The enormous risks of defense contracting are further reflected in particular programs that have been well-publicized. Grumman lost $260 million on the F-14 fighter program; Lockheed lost $484 million on a group of Government contracts, including the C-5A, Cheyenne helicopter, and SRAM missile motor, which were settled as a package in 1970; General Dynamics lost $359 million in building the SSN688-Class submarine. This list would be much longer if smaller companies were added. Arguments over efficiency, management, cost controls, technological problems, or otherwise are irrelevant in the present analysis; these numbers represent actual losses incurred that are deductible for federal tax purposes.

The cases are not limited to defense contracts. Lockheed announced in December, 1981, the discontinuance of the L-1011 program, with 1981 losses in excess of $800 million, following the previous recording of nearly $1.7 billion in losses on that program in the years 1968-1980. There have been other major commercial airplane programs in the last twenty years that have also resulted in major unexpected losses.

In the case of virtually all of these programs, the products were originally priced by both parties to yield a profit. The incredible technological developments in the aerospace industry in the last three decades have made it impossible to forecast costs, and thus prices, with the degree of accuracy required for effective tax administration. Contractors are frequently required to commit to prices before the product to be developed and manufactured has even been invented. The development and production of the end products is in a state of constant flux, both engineering-wise and cost-wise. The engineering changes on programs such as those above can range from 500 to over 6,000 or more during the course of a typical contract. There is no way to determine with reasonable certainty whether the manufacture and delivery of the products based on the initial cost estimates, and thus the contract price, will result in profits or losses.

The profit and loss uncertainties of the aerospace industry are further compounded by the Government procurement concept of "unallowable" costs. All Government contractors are required by Public Law 87-653 to make full disclosure of all anticipated costs in negotiating significant contracts and contract amendments. Pricing cannot, for the most part, reflect costs such as interest, advertising, or contributions, although these costs are very substantial in this industry, even with respect to Government business. In addition, other major costs are only allowable within strict limits, including, but not limited to, research and development costs, bid and proposal costs, and certain professional services. Studies have shown that these unallow-

able costs exced 1.5 percent of sales, reducing before-tax earnings by 25 to 30 percent.

A 1974 report by the General Accounting Office [12] reviews the "cost growth" in major weapons systems up until that time. The unanticipated cost-growth of 55 major weapons systems received was over $7 billion in six months' time. The report concludes as follows:

Cost growth in major weapon systems results from such things as unanticipated development difficulties, faulty planning, poor management, bad estimating, or underestimating. However, not all cost growth can reasonably be prevented. For instance, unusual periods of inflation may result in cost growth. Changes in technology may make it possible to incorporate modifications that result in an overall increase in the system's effectiveness. Such cost growth cannot always be anticipated, particularly when a weapon system is in development and production over long periods.

The statement that "not all cost growth can reasonably be prevented" is a significant understatement of the experience of the aerospace industry.

The Unique risks of defense contracting are vividly illustrated by the magnitude of the cost and effort merely to compete for contracts. Agency requests to industry to submit proposals for programs such as SRAM missile, Cheyenne helicopter, C-5A, and B-1 aircraft average 1,000 to 2,000 pages, and contractors' responses normally range between 15,000 and 30,000 pages.[13] One contractor expended $25 million in costs to compete for the F-15 contract, which it lost. In the case of the B-1 program, the Air Force spent $140 million on feasibility and other studies during 1965-70 to write the development specifications. Several companies spent $66 million while preparing and waiting for receipt of the request for proposals and five companies spent $36 million in company funds responding to the request. In short, it cost nearly one quarter billion dollars to prepare for the B-1 competition, to prepare the proposals, and to await the source selection decisions.[14]

The Department of Defense reported to Congress that major defense contractors incurred $3.3 billion in bid and proposal and independent research and development costs in fiscal year 1980. As a result of regulatory provisions limiting allocation of such costs to Government contracts, the Defense Department accepted only $2.6 billion of such costs for allocation to all of the contractors' work, commercial and Government. The share paid by the Department of Defense was $1.4 billion.

B. Cost-type contracts.—Popular misconceptions exist that contractors in the defense industry are assured of recovery of their costs under cost-type contracts and that accrual of profit with reasonable certainty is possible. Nothing could be further from the actual facts.

Some cost-type contracts, whether cost plus fixed fee, cost plus award fee, or cost plus incentive fee, include maximum cost recovery provisions, exposing the contractor to substantial risk of loss of profits, or even some risk of loss. Some cost-type contracts give the Government an option to purchase additional quantities at fixed prices, or on a fixed price incentive contract basis, which subjects the contractor to major risk of loss of profit, or actual loss, when the cost-type contract and the fixed price option are considered together. Further, in any cost type contract, the contractor is always at risk of loss of all or part of the fee because of "unallowable" costs, as previously described. The fixed fee on a CPFF contract will often be only in the 3 percent to 7 percent range, and unallowable costs can substantially reduce or posibly exhaust this narrow profit margin.

In the case of cost plus award fee contracts, the contractor's fee is entirely at the judgment of the Contracting Officer. This judgment ordinarily is not rendered until near the completion of the contract, when the most critical performance tests occur. The fee may range from 0 percent to 15 percent at the Contracting Officer's discretion. An interim award, say at 7.5 percent, can be eliminated by a final award of 0 percent. There is no way the fee can be accrued until the completion of the contract under traditional tax accounting principles—when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.[15]

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[12] *Report to the Congress, status of Selected Major Weapons Systems,* Comptroller General of the United States (May 13, 1974).

[13] One program proposal to the Air Force for the AWACS contained 26,000 pages and involved 16,000 people in its preparation. Printed proposal material submitted by the three airframe and two engine contractors on the C-5A competition totalled 240,000 pages.

[14] Report of the Commission on Government procurement, December, 1972, Vol. 2, p. 137.

[15] Reg. § 1.451-1(a) (italics added).

In the case of cost plus incentive fee contracts, the same uncertainty exists until contract completion. Under a particular contract for a major acquisition of missiles, the "target" fee was to be 8 percent of estimated total "target" cost. The cost incentive provisions stated that cost overruns could reduce the fee to 5 percent and cost underruns could increase the fee to a maximum of 11 percent of cost. Performance incentives could further reduce or increase the fee by as much as 3 percent of costs. Thus, the fee could be as little as 2 percent or as much as 14 percent.

The performance incentives under the foregoing contract were heavily weighted toward flight tests and accuracy tests, which would occur in the last six months of a contract expected to require five years to perform. If the contractor were to accrue a fee of, say, 8 percent of costs incurred in the early stages of performance, a disastrous flight test and cost overruns could easily result in the necessity of booking a large negative fee in a very small amount of "sales" in the last year of performance. This is not the kind of certainty required for accrual of income for tax purposes.

Cost reimbursement contracts are used in those cases in which there is the most cost uncertainty. They are used where the work is essentially developmental in nature and thus where there is an inability to estimate costs to provide a basis for a fixed price type of contract. There is no comparable cost experience on any other contract, and no other reliable basis on which to determine costs.

In a very real sense, the completed contract method is most appropriate for cost-type contracts.

C. Other existing tax accounting methods are not proper.—The Treasury Department seeks to prescribe a new method of tax accounting, the progress payment method, for all long-term contracts, whether or not the taxpayer was previously using the completed contract method. Treasury would thereby discriminate against all businesses with long-term contracts, denying them the use of the traditional accrual method of accounting. This is done presumably to prevent such taxpayers from treating as cost-of-sales of initial units delivered the actual costs of those units, because this might result in substantial losses. Further, it prevents them from using the cost-or-market inventory convention to reflect losses at the earliest time those losses could be reasonably estimated.[16]

This draconian solution of prescribing a new accounting concept made up out of whole cloth, with all the uncertainties it would bring, is wholly unnecessary. The completed contract method will work quite properly to require income to be reported when it is actually earned, and to deny the deduction of losses until they are actually sustained, with some changes in the regulations. There simply is no other tax accounting convention that is suitable to the unique problems of determining income or loss in the aerospace industry, as previously demonstrated. These same difficulties exist in the shipbuilding, heavy machinery, and construction industries.

The Treasury Department would permit use of the percentage-of-completion method, but their own explanation indicates that it is not suitable: However, it may be recognized that requiring this method in all cases may be difficult to administer and burdensome to taxpayers.[17]

This is a significant understatement. The percentage-of-completion method requires a determination of the degree of cost completion or physicial completion of contracts.[18] There is a substantial amount of subjective judgment applied in the use of the percentage-of-completion method. It is not possible in the aerospace industry (or probably any other industry) to make these determinations with sufficient accuracy for tax purposes, which requires annual tax accounting based on a reasonably high degree of certainty and objectivity.

It was this very impossibility, and the uncertainty of using estimates of future performance, that led to extensive reconsideration and the changes in the completed contract regulations in 1971.[19] The IRS should not be satisfied with a tax accounting methods which determines profits and losses in any given year by contractor estimates of future costs or future performance. Because of the inherent difficulties in the aerospace industry in determining costs and prices under contracts until they are completed, profits and losses cannot readily be determined with respect to particular years; a transactional approach is essential. Thus, for example, the sophisti-

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[16] See *Space Controls, Inc.* v. *C.I.R.*, supra, and *E.W. Bliss Company* v. *United States*, supra, footnote 3. But see *Rockwell International Corp.* v. *Commissioner*, supra, footnote 3.

[17] General and Technical Explanations of Tax Revisions and Improved Collection and Enforcement Proposals, Department of the Treasury, February 26, 1982, Completed Contract Method of Accounting, (hereinafter referred to as General and Technical Explanations), General Explanation, p. 4.

[18] See Reg. § 1.451-3(c)(2).

[19] See, supra, pp. 7-13.

cated pricing techniques for aerospace products may make it impossible to determine profits or losses on a year-by-year basis. The uncertainties in costs created by double-digit inflation and by the continuing gallloping pace of technological change compound the difficulties. The uncertainty and controversy that existed prior to 1971 must not arise again. Lessons should be learned from the past. There is virtue in stability and certainty, particularly as to tax liabilities, indeed, it is a necessity.[20]

The Treasury's proposed "progress payment method" does not respond to these unique tax accounting difficulties. Indeed, it is so unsound in principle and in practical application that it would be disastrous to adopt it.[21]

IV. THE ADVERSE IMPACT OF DENIAL OF THE COMPLETED CONTRACT METHOD UPON OUR NATIONAL DEFENSE

Serious questions presently exist as to the capability of the United States defense industrial base to fulfill effectively its critical role in national security. In testimony before the Defense Industrial Base Panel, General Alton Slay, Commander of the Air Force Systems Command, observed that the United States had been able to generate a massive surge to mobilize its manpower and industrial base in the past, but that, today, the United States defense industrial base lacks standby capacity, weapons systems are more complex, "and we would be caught flat-footed for even the basic materials from which defense articles are made." [22]

The Administration is sponsoring increase in the procurement of defense products of the most sophisticated nature, placing further stains upon the capacities of our defense industrial base. The completed contract method contributes to severely-needed funds in the aerospace industry for both working capital and new capital investment. This is essential to a rejuvenated defense program. The Accelerated Cost Recovery System can provide only limited benefits, because many companies in the industry are more labor-intensive than fixed asset-intensive, as contrasted with other major United States industries.

It is sometimes overlooked that defense contractors typically have large net investments in work in process under Government contracts as well as under commercial contracts. While the cost of operating capital necessary to finance work in process has increased dramatically, the cost of money for operating capital is not an allowable cost under defense contracts. The usual progress payment has been 80 percent of costs for contractors other than small business (increased to 90 percent in late 1981). Because of time lags in recording costs, submitting billings, and receiving payment, a recent industry survey indicated that progress payments provide only about 60 percent of the working capital investment and the contractor must provide the balance of 40 percent (which should drop to about 30 percent with 90 percent progress payments).[23]

A recent analysis by experts from the Defense Systems Management College [24] graphically demonstrates how inadequate cash flow under defense contracts seriously erodes profits and provides a strong disincentive to capital investment by companies in the defense industry. For example, the analysis shows that a negotiated profit rate of 12 percent is reduced to an actual realized profit of 6 percent where the contractor's cost of borrowed funds is 15 percent, a 30-day lag exists between submission of invoices and receipt of payment, and the rate of progress payments is 80 percent. The analysis concludes that the United States defense industry is seriously under-capitalized, that more and more companies are abandoning defense business because it is unstable and produces generally low profits, that investment in the defense industry is discouraged by cash flow problems, unfavorable depreciation laws and tax policies, inflation and the cost of borrowing, and that contract financing and tax policies must be changed to encourage the flow of companies into the defense industry and greater capital investment therein. Withdrawal or substantial curtailment of the right to use the completed contract method will have exactly the opposite effect—requiring greater industry reliance on borrowing, further eroding profits and discouraging capital investment, and driving more companies from the defense business.

As previously demonstrated, a major purpose of the revision of the long-term contract regulations in the period 1971–1976 was to attract the aerospace industry into that tax accounting system to provide reasonable certainty of tax consequences and

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[20] *Report of the President's Task Force on Business Taxation*, September. 1970.
[21] See, infra, pp. 31–38.
[22] *Federal Contracts Report*, Bureau of National Affairs, Vol. 857, Nov. 17, 1980, p. A–25.
[23] *Federal Contracts Report*, Bureau of National Affairs, No. 864, January 12, 1981, p. D–7.
[24] "Financing Defense Systems Programs", *Concepts*, The Journal of Defense Systems Acquisition Management, Frisch & Acker, Autumn 1981, Vol. 4, No. 4.

forestall acceleration of estimated losses. The Treasury's program was successful, with virtually all major aerospace contractors now having adopted the method. A recent, informal survey of twenty-two major aerospace defense contractors was conducted. About one-half of these companies reported that the deferred tax liability attributable to the completed contract method is now equivalent in amount to 25 percent of the shareholder equity of these companies.

As noted previously, withdrawal or substantial curtailment of the right to use the completed contract method will cause tremendous uncertainty in the aerospace industry. Years of litigation may ensue, which will affect significantly the financial positions of companies and force them to make important operating decisions without any degree of certainty as to the outcome.

Under the conditions, any such withdrawal or substantial curtailment could have very serious adverse effects on United States defense capabilities and on this industry. It would require the industry to go to the financial markets for massive amounts of new capital. The industry is already poorly-rated by the financial markets, and new capital would be obtained, if at all, only at unduly-high interest rates. Weaker companies, though owning facilities which are vital to our national defense industrial base capacity, could be forced into unwise mergers. In extreme cases, for national security reasons, Government intervention might be necessary.

Although interest for the most part is not an allowable cost for defense pricing purposes, it obviously must be recovered by aerospace companies in the pricing of their products. Accordingly, profit percentages on defense contracts necessarily reflect the interest and other debt service costs of the contractor. The Government has recovered much of the benefit of the completed contract method through lower prices, resulting from reduced profit rates made possible by the deferral in time of payment of contractors' tax liabilities. If the industry must incur market interest costs on borrowings to replace this capital, the Government will bear much of the cost in higher profit rates on new defense contracts; otherwise, the defense industrial base will be eroded. To the extent the cost of borrowing in the marketplace exceeds the implicit interest rate borne by the United States on its debt, or earned on its funds, the Government will incur added defense costs unnecessarily.

More importantly, in any transition process, the United States will lose much of the dynamic progress presently underway in the aerospace industry in improving its productive capacity, its efficiency, its investment in new independent research and development, and its capital planning. This progress has been ignited by the President's determined program to increase defense expenditures so as to improve our strategic position, our defense capacity, our defense industrial base, and our research in new weapons systems and aerospace science. The Department of Defense has been promoting these developments by new initiatives such as flexible progress payments, economic price adjustment clauses, and multi-year procurement commitments.

In summary, if a major change in use of the completed contract method is to have any substantial revenue effect, the defense posture of the United States would be jeopardized in many ways. The Government would lose more than it would gain.

V. THE TREASURY DEPARTMENT'S PROGRESS PAYMENT METHOD WOULD BE COMPLETELY UNWORKABLE AND INEQUITABLE

The Treasury Department proposes to require that the "progress payment" method or the percentage of completion method be used for all "long-term contracts".[25] As previously indicated, the Treasury recognizes that virtually no one would use the percentage of completion method.[26] Thus, all businesses manufacturing special order products normally requiring more than one year to complete, and all of the construction industry, would be forced to use this new "progress payment" method whether or not they have been using the completed contract method. For example, a small businessman producing special order products requiring more than one year to manufacture who uses the traditional accrual method of accounting, capitalizing his direct and indirect production costs as inventory, will be forced to use this new method even though he has had absolutely no problem with the IRS as to his tax accounting method. The results of this change would be absolutely chaotic.

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[25] A "long-term contract" is a building, installation, construction, or manufacturing contract which is not completed within the taxable year in which it is entered into for unique items not normally carried in inventory and which normally require more than twelve calendar months to complete. Reg. § 1.451-3(b)(1).

[26] See, supra, pp. 24-25, and footnote 17.

The Treasury's new "progress payment" method would cause severe tax accounting difficulties. These difficulties are so great that Treasury itself, although it announced the new method only twenty-one days ago,[27] is already discussing substantial changes in its written proposal.

The proposed new method has major conceptual and practical flaws. It sounds like a cost-recovery method, a thoroughly unsatisfactory concept for tax accounting and one which this Committee only recently disfavored.[28] It requires that borrowings in lieu of payment be treated as income.[29] This may raise Constitutional risks; receipt of the proceeds of a loan is not "income" within the scope of the Sixteenth Amendment.[30] Furthermore, it is utterly impractical to determine whether borrowings are "in lieu of payment". If the purchaser lends the seller funds and takes a lien on his general assets, rather than having such loans "secured by the contract", presumably the amount is not treated as income. This will lead to artificial, contrived, arrangements and cause differing treatment of similarly-situated taxpayers.

Treasury itself recognizes that this "borrowing" rule presents difficulties and has proposed that the amount be taken into income ratably over a twelve-month period.[31] It appears Treasury is already considering variations of this rule, but the rule itself is wrong in principle, and all of the difficulties it will create cannot be foreseen.

An even more fundamental objection to the "progress payment" method is that it would not allow losses on the contract to offset profits on another.[32] Similarly, Treasury has advised that if under the method, profits are reported on a particular contract, but later losses are incurred on that contract, the losses cannot be used to offset the profits reported earlier and cannot be deducted until some future year when net cash flow arises or upon completion of the contract. These rules will result in taxpayers being required to report phantom profits that never exist, and they further compound the Constitutional infirmities of the new method. There is virtually no precedent in our income tax system for denying a taxpayer the right to offset losses within a single business against profits on other transactions within that business. The elaborate carryback and carryforward provisions of the Internal Revenue Code are adequate evidence of a policy to permit profits and losses to be offset so that only true income is taxed.

The Treasury proposals call for a new concept of allocating virtually all indirect costs to long-term contracts even though they do not directly benefit the performance of those contracts.[33] This would reverse seventy years of tax accounting history in our income tax system and create extraordinary uncertainties and inequities.

The existing long-term contract regulations already require that both direct and indirect costs attributable to particular long-term contracts be allocated to those contracts; the result of this treatment is that deduction of the costs is deferred under the completed contract method until contract completion, when either the profit or loss from the contract is determined. The regulations permit the current deduction as period costs of expenses that benefit the taxpayer's "activities as a whole", such as the salary of the president of the corporation. This regime is, with some exceptions, consistent with the tax treatment of business taxpayers in general under the inventory regulations, where precisely the same types of cost allocation rules are required. These inventory regulations, in turn, are based on traditional financial accounting and tax accounting concepts, and they represent the product of a long history of experience and adaptation to developing principles of financial accounting and cost accounting.

The Treasury's proposed new requirement for comprehensive allocation of virtually all indirect costs, even those not directly benefitting performance of long-term contracts, has no basis in financial accounting, cost accounting, or tax accounting, and will be completely unworkable. How, for example, is interest on general corporate borrowings, such as a long-term bond issue to build new facilities, to be allocated to particular long-term contracts? The Defense Department does not permit interest to be allocated as a cost under defense contracts. The virtual impossibility of allocating interest expense effectively under § 265(2) of the Internal Revenue Code is well-known to all tax professionals.

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[27] See footnote 17, supra.

[28] H.R. Rep. 96-1042, 96th Cong., 2d Sess. 19, 21 (1980) (H.R. 6883, Installment Sales Revision Act of 1980).

[29] General and Technical Explanations, pp. 4, 9.

[30] *Consolidated-Hammer Dry Plate & Film Company* v. *CIR*, 317 F. 2d 829 (7th Cir. 1963); *United States* v. *Ivey*, 414 F. 2d 199 (5th Cir. 1969).

[31] General and Technical Explanation, p. 9.

[32] General and Technical Explanation, p. 10.

[33] General and Technical Explanation, pp. 7, 9.

Treasury would require allocation, and thus denial of a current deduction, for some research and experimental expenses.[34] This flies in the face of a deliberate Congressional policy in Code § 174 to encourage research and development by allowing a current deduction for all such costs. Treasury would require allocation, and thus denial of a current deduction, for all Accelerated Cost Recovery System (ACRS) depreciation amounts, to the extent allocable to long-term contracts. Treasury would thereby discriminate against taxpayers with long-term contracts by denying them the immediate benefits of the tax incentives just adopted by Congress in the Economic Recovery Tax Act of 1981 for new capital investment in plant and equipment.

These rules make no sense whatsoever.

Treasury provides no guidance for the allocation of indirect costs not related to the performance of particular long-term contracts. There are no precedents for allocation of these costs for tax purposes. The Treasury's proposed rules for such comprehensive cost allocations are far more extensive than the rules generally applicable to accrual basis taxpayers maintaining inventories. Yet, there is no reason in principle why a taxpayer manufacturing special order goods (requiring more than twelve months to produce) should be forced to capitalize and defer the deduction of costs that other manufacturers may deduct currently. These costs are period costs; they are not costs of manufacturing the product sold by the business. They are costs which occur regardless of the amount of product manufactured.

The result of the Treasury's proposal would be that a tremendous pressure would arise for a long-term contractor to restructure his business operations so that his contracts ceased to be "long-term contracts". By avoiding such classification, he could utilize the more reasonable cost allocation rules applicable to accrual basis taxpayers in general.

This pressure will cause great complexity, uncertainty, and litigation. In the past, taxpayers have often sought to have their business operations classified as "long-term contracts" so that they could obtain the certainty of tax treatment offered by the completed contract method. There has been no incentive deliberately to avoid such classification, since the taxpayer was always free to use the traditional accrual method for tax purposes if he chose. Now, however, there will be a strong, new incentive to avoid classification of activities as "long-term contracts". This is a very difficult determination to make, as should be evident from a study of the definition of a "long-term contract" in the existing regulations.[35] The Treasury's proposed new regime will cause chaos in business tax reporting for a wide range of businesses.

There is no need for all the uncertainty, inequity, and complexity that this major change in tax accounting would bring. The completed contract method can be refined by changes in the regulations which will eliminate the problems which have arisen in its operation. The Aerospace Industries Association has suggested a number of possible changes to the Treasury Department and has offered to participate in an intensive dialogue to help resolve other concerns of Treasury. The changes, however, must be entirely consistent with the provisions governing business taxpayers in general under the inventory regulations. Any other approach will result in intolerable inequities and complexities.

VI. REVENUE IMPACT

The revenue consequences of withdrawal or substantial curtailment of use of the completed contract method by the aerospace industry would be quite uncertain. A reasonable transition rule would be an absolute necessity. The Treasury Department proposes a so-called cut-off method whereby long-term contracts entered into before February 26, 1982, could continue to be reported on the completed contract method, using the old cost allocation rules, by a taxpayer presently using that method; long-term contracts entered into between February 26, 1982, and December 31, 1982, by such a taxpayer would be reported until December 31, 1982, on the completed contract method using the old cost allocation rules and thereafter on the progress payments method; and long-term contracts entered into after December 31, 1982, would in the case of all taxpayers be reported on the progress payment method.

If the Treasury's proposals were to be adopted, this seems unduly complex. At the very least, long-term contracts entered into before December 31, 1982, should continue to be reported on the completed contract method, using the old cost allocation rules, by a taxpayer using that method.

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[34] General and Technical Explanation, pp. 7, 9.

[35] See footnote 25, supra.

More importantly, the Treasury proposal provides far less transitional relief than it suggests because it makes costs deducted under the old cost allocation rules in years after 1982 a "tax preference" for proposes of the Treasury's proposed new corporate minimum tax.[36] This effectively cancels out about one-third of the benefit of the transition rule. There is no reasonable basis for this treatment.

The Treasury's proposal applying the proposed new corporate minimum tax to long-term contracts entered into in prior years is particularly harsh and unjustified, and it would impose a severe, added financial burden on the aerospace industry. The minimum tax would be imposed even though the contract ultimately results in a loss. This is perverse. All of the other listed tax preferences always result in a tax benefit to the taxpayer. Here, however, the minimum tax may be imposed even though the completed contract method has served to defer a loss deduction—resulting in a tax preference to the Government.

To the extent that Congress were to provide more reasonable transition rules, and to the extent Congress were to require less-draconian cost allocation rules, the revenue from this poorly-conceived Treasury proposal to require the progress payment method for all long-term contracts would be less. The revenue gain in the 1983, 1984, 1985 period would become far less significant, so that the change would have little impact on the projected three-digit deficits in the next several years.

In the case of new contracts resulting from increased defense expenditures, or otherwise, the impact will be delayed substantially. Contracts in the aerospace industry, whether defense or commercial, typically involve long lead-times from the time of execution until the time when substantial production activity is undertaken and deliveries are made.

Thus, it may be unlikely that withdrawal or substantial curtailment of use of the completed contract method by the aerospace industry will begin to have any substantial revenue consequences until 1985 or 1986. This does not mitigate the adverse impacts of any such action upon defense policy,[37] however, since the capital planning of the industry would be disrupted by the action itself, even though its revenue impacts were delayed several years in time.

VII. CONCLUSION

The use of the completed contract method is vital to proper tax accounting in, and to the financial stability of, the aerospace industry. There is no reasonable alternative that might not allow either undue acceleration of losses that may not be actually incurred, on the one hand, or the reporting of taxable income that may never materialize, on the other hand. The risks and uncertainties of the aerospace industry are extraordinary and unique, and unanticipated "cost-growth" in major weapons systems is the rule rather than the exception. The pricing and costing of products of the aerospace industry necessarily reflect major technological uncertainties and are only fairly reflected for tax purposes by the completed contract method.

The Treasury Department carefully developed the completed contract method in regulations in the 1971–76 period for, among other purposes, the objective of resolving the tax accounting treatment of the aerospace industry. This thorough consideration and evaluation should not be abandoned.

The aerospace industry responded by accepting the Treasury's invitation to use the completed contract method almost on a universal basis. The result is that a large part of the operating capital of the industry is now reflected in deferred tax liabilities attributable to the completed contract method. A withdrawal or substantial curtailment of the method could have severe adverse impacts on the aerospace industry and thus on the United States defense industrial base. The ACRS system is by no means a substitute. The important initiative in capital planning, increased efficiency, independent research and development and increased capacity which have been stimulated in the aerospace industry by the present Administration should not be disrupted by such a tax change.

The Treasury Department's proposed alternative tax accounting method, the "progress payments" method, would have disastrous effects. The method seeks to treat as income borrowed funds. It specifically denies taxpayers the right to combine profits on some contracts and losses on other contracts, or even profits and losses on the same contract in different years, to determine their real income. It denies current deduction of certain research and development costs and the new Accelerated Cost Recovery System deductions. It requires cost allocations to long-term contracts that cannot reasonably or fairly be made. It denies businesses with long-term contracts the existing, reasonable cost allocation rules for all other businesses.

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[36] General and Technical Explanation, p. 12; see also General and Technical Explanation, Corporate Minimum Tax pp. 42, 50–51.

[37] See, supra, pp. 26–31.

These circumstances will create strong incentives for business to rearrange their business transactions so that they are not "long-term contracts" simply to avoid the unreasonable new cost allocation rules. The net result of the Treasury's new method will be to create massive confusion, uncertainties, complexities, administrative difficulties for the IRS, and inequities inasmuch as similarly-situated business taxpayers will be treated differently. It should be sharply rejected.

The revenue effect of the Treasury's proposals will be highly uncertain in the near term (1983–1985). This results from the necessity of appropriate transition rules and the delayed effect of any such change. Major tax accounting controversies will result from the abandonment or substantial modification of the completed contract method and forced adoption of the progress payment method. The consequences may be as destructive for the Treasury Department as for the aerospace industry. To make such changes and label them as a "loophole closer", in view of the Treasury's original intent in this area to raise revenue, is to distort the history of the development of the completed contract method.

This Committee should immediately advise the Treasury Department not to issue any proposed regulations until the issues involved have been considered by the Committee. The Committee ultimately should resolve this matter by advising the Treasury Department to revise the long-term contract regulations to preserve the completed contract method but to eliminate any undue benefits in its application as demonstrated by experience over the last ten years. The cost allocation rules should be revised to achieve greater consistency with the regulations governing all other business taxpayers—that is, accrual basis taxpayers maintaining inventories. There will be significant revenue gains to the Federal Government from such changes. The Aerospace Industries Association has already made many constructive suggestions to the Treasury Department to achieve these objectives and stands ready to engage in a continuing dialog with Treasury to achieve greater equity, simplicity, and consistency in the tax treatment of long-term contracts.

Mr. STARK [presiding]. Thank you, Mr. Nolan.

Mr. Bushman.

STATEMENT OF JAMES E. BUSHMAN, C.P.A., CHAIRMAN, TAX ACCOUNTING SUBCOMMITTEE OF THE FEDERAL DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. BUSHMAN. My name is James E. Bushman, a C.P.A. from Cincinnati, Ohio. I am chairman of the Tax Accounting Subcommittee of the Federal Tax Division of the American Institute of Certified Public Accountants [AICPA]. The AICPA is the national professional organization for C.P.A.'s, and has over 170,000 members who will work extensively with the issues before you at these hearings.

I am testifying against the administration's proposal to eliminate or severely restrict the use of the completed contract method of accounting. Our organization will submit a statement for the record on several other issues included in Treasury Improved Collection and Enforcement Proposals.

In the interest of time, I would like to summarize what we feel to be the most important point included in our statement. We disagree with Treasury's stated reasons for elimination of the method; namely, that the percentage of completion method yields a better measure of income than does the completed contract method.

Both methods represent generally accepted accounting principles for the purpose of presentation in financial statements. For financial statement purposes, however, the percentage of completion method has been found to be preferable in certain instances. The Treasury's proposals, we believe, improperly conclude that because the percentage of completion method is at times preferable under GAAP; it is preferable in the computation of income for Federal tax purposes.

The Treasury's conclusion, therefore, is that the completed contract method should be repealed.

This conclusion fails to recognize the clear differences in objectives and standards that exist between GAAP and tax accounting rules. This difference in objectives and standards has been recognized in our system of taxation for many years. The dichotomy that exists was summarized by the Supreme Court in its decision in *Thor Power Tool Co.* The Court in that decision denied deductions for inventory reserves conceded to be appropriate under GAAP.

In so doing, the court stated:

> * * * Given the diversity, even contrariety of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable. This difference in objectives is mirrored in numerous differences of treatment. Where the tax law requires that a deduction be deferred until "all the events" have occurred that will make it fixed and certain * * * accounting principles typically require that a liability be accrued as soon as it can be reasonably estimated * * * Financial accounting is, in short, hospitable to estimates, probabilities and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty * * *

We believe that the completed contract method, applied properly, can produce a result totally consistent with the concepts of tax accounting embodied in the long-standing tax accounting principles of certainty and all events. We feel certain that the IRS would view the accrual method as set forth in sections 451 and 461 as the best method of reporting income for taxpayers not having long-term contracts. Under this method, income accrues when all events occur to fix a taxpayer's right to the income. Deductions for cost of goods sold are deferred until the sale is completed.

For contractors having long-term contracts, the completed contract method most closely parallels the tax concept of all events applied to other types of taxpayers. Only when a contract is completed and accepted does a contractor have a right to his income.

Further, total contract expenses are known only when the contract is complete. Because of this, the completed contract method, we believe, matches more closely with the tax accounting principles applied to other types of taxpayers without questions.

To find the completed contract unacceptable for tax purposes because it may be less preferable for use in financial statements which have different objectives and standards, ignores the fact that it is consistent with concepts that have been in our tax law over 65 years.

If Treasury demonstrates that there is a widespread pattern of abuses or inequities stemming from the use of the method remedial regulatory action could resolve these matters without eliminating a time-tested and valid method of reporting.

[The prepared statement follows:]

STATEMENT OF JAMES E. BUSHMAN, C.P.A., CHAIRMAN, TAX ACCOUNTING SUBCOMMITTEE OF THE FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Good morning! My name is James E. Bushman, and I am the Chairman of the Tax Accounting Subcommittee of the Federal Tax Division of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national professional organization for CPAs, and has over 170,000 members who will work extensively with the issues before you at these hearings. I am testfying against the Administration's proposal to eliminate or severly restrict the use of the completed contract

method of accounting. Our organization will submit a statement for the record on several other issues with which we are concerned.

BACKGROUND

The completed contract method has been an accepted method of accounting for Federal income tax purposes for well over 60 years. It is a method of tax accounting that accurately measures a contractor's income and has withstood the test of time as clearly reflecting taxable income.

Without question, the completed contract method is one of the most easily understood and widely used methods of accounting under the Income Tax Regulations. The method operates to tax a contractor's income at the one point in time when the income or loss on the contract is known—the time of completion and acceptance. It is for this reason that the completed contract method is so widely accepted in all aspects of contracting industries whether they be construction, installation or manufacturing contracts. With one fixed point for gain or loss recognition, all guesswork or estimation is eliminated and a contractor can report with certainty the resulting gain or loss on the contract.

The Treasury Department in 1976 culminated a five-year regulations project by issuing new long-term contract regulations. The purpose of revising the existing long-term contract regulations in 1976 was not to curb abuses or close various loopholes. On the contrary, the regulations were revised so that previously existing case law could be elevated to the status of regulations and provide a higher degree of certainty and ease of Administration for both the Treasury Department and taxpayers in dealing with long-term contract issues.

Despite the repeated attempts in the various draft regulations to place restrictions on the use of completed contract and/or percentage of completion, the Treasury Department eventually determined that no such restrictions were needed. This decision, we believe, was premised on the fact that these methods had been in the regulations for so many years and had clearly reflected income for so long that any change could not be based upon a clear reflection of income standard. Thus, the final regulations issued on January 14, 1976, reflected not only a careful and thoughtful decision to extend the use of the completed contract method but also a decision to put to rest any question regarding the clear reflection of income.

TREASURY PROPOSAL—RATIONALE

The Treasury release, in describing current law relating to the orginal long-term contract methods, concludes that the percentage of completion method yields a better measure of income than the completed contract method. The stated reasons for this conclusion are that the percentage of completion method recognizes that income is earned over the course of a long-term contract and because it provides for a better matching of income and expenses.

The proposal indicates that the completed contract method permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices.

This statement is apparently based upon the premise that since the percentage of completion method is preferable in certain instances to the completed contract method for financial reporting purposes, the completed contract method improperly defers the measurement of income for Federal income tax purposes.

GENERAL COMMENTS ON TREASURY PROPOSALS

The explantion of both the current situation and reasons for change represent a distorted and contradictory analysis of generally accepted accounting principles (GAAP) and their relationship to tax accounting for Federal income tax purposes. The proposal improperly refers to GAAP to justify the repeal of the completed contract method but finds no basis under GAAP in developing the new "progress payment" method of accounting for long-term contracts.

Perhaps the most disturbing aspect of the legislative proposal is the fact that it would apply a special set of tax accounting rules to contractors that are totally different from the tax accounting rules applied to taxpayers in other segments of our economy. The proposal results in a system of taxation being applied to contractors that cannot be reconciled with the system being applied to similarly situated accrual method manufacturers, merchandisers and providers of service, who do not utilize the long-term contract methods.

Without any explanation or analysis, the proposal states that the percentage of completion method best reflects the taxpayer's income from a conceptual stand-

point. This statement may result in part from the fact that the AICPA has stated that although both the percentage of completion and completed contracts methods are acceptable under GAAP, the percentage of completion method is preferable for long-term contracts. The proposal further presumably assumes that since under GAAP the percentage of completion method is at times preferred, the completed contract method improperly defers the measurement of income for Federal tax purposes. This conclusion fails to recognize the clear differences in objectives and standards that exist for financial statement and tax purposes. This difference in objectives and standards was clearly recognized in the Suprement Court's decision in *Thor Power Tool Co.* v. *Commissioner, 439 U.S. 522 (1979).* The Court, in denying the taxpayer a deduction for inventory reserves, conceded that these reserves were proper under GAAP but recognized that * * * Given the diversity, even contrarity of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable. This difference in objectives is mirrored in numberious differences of treatment. Where the tax law requires that a deduction be deferred until "all the events" have occurred that will make it fixed and certain * * * accounting principles typically require that a liability be accrued as soon as it can be reasonbly estimated * * * Financial accounting is, in short, hospitable to estimates, probabilities and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty * * * *(Thor Power Tool Co.* v. *Commissioner,* 439 U.S. 522, 542-3 (1979).)

Treasury's analysis ignores these considerations.

We have no doubt that the Internal Revenue Service would view the accrual method as being the "best method" of accounting for tax purposes. Not necessarily the accrual method that may be used for financial statement purposes (which can at times include reasonable estimates in application), but rather the accrual method under the regulations of sections 451 and 461 of the Code with the familiar "all events test."

It is interesting to note that the completed contract method for long-term contracts in most respects parallels the accrual method. Income "accrues" under the completed contract method when all events occur to fix the right to receive *all* of the income under a contract, that is when it is completed and accepted. Likewise, expenses are not recognized until the subject matter of the contract is completed similar to the inventory accounting rules under the accrual method. Viewed in this light, the completed contract method perfectly matches income and expenses under the "all events test." The Treasury Department failed to even recognize this fact in its legislative and regulatory proposals.

Under the "all events test" income and expenses accrue when all events have occurred to fix the right to receive the income or the obligation to pay the expense, and the amounts can be determined with reasonable accuracy. The accrual method of accounting obviously originated as a financial accounting concept and thus was originally adopted by Congress as an acceptable method because of its wide business use. The refined "accrual method" as known today and used in a tax accounting sense is a product of judicial and regulatory refinements. There is certainly no doubt that the accrual method of accounting "clearly reflects income" as that term is used in section 446 of the Code.

The essence of our objection to the stated reasons for change is that Treasury has failed to mention the fact that the completed contract method has survived the test of time over a 65 year period and matches up step for step with the theoretically best method of tax accounting in terms of clearly reflecting income. Instead, Treasury has established an unsupported "clear reflection of income" premise to make it appear that the completed contract method is a poor measure of taxable income for long-term contracts. The completed contract method, we feel, properly reports the taxable income of taxpayers involved in highly competitive industries that are subject to significant business risks and uncertainties. Treasury's proposal paints an invalid picture, with a worst case scenario of an aggressive taxpayer who pushes the "completed and accepted" and "costing" rules of the completed contract method to their limits, in justifying its elimination.

If it is perceived that there is a wide spread pattern of abuses or inequities stemming from the existing regulations remedial regulatory action could resolve these matters, without eliminating a time-tested and valid method of reporting.

In summary, the Treasury proposal is ill-conceived and so loosely worded and broad based as to sweep within its ambit taxpayers who have never used any special accounting methods (completed contract or percentage of completion) for long-term contracts. The accounting changes proposed will require extensive and onerous record keeping which would be burdensome fo taxpayers of any size.

Mr. STARK. Mr. Schneider.

STATEMENT OF LESLIE J. SCHNEIDER, COUNSEL, COMMITTEE TO PRESERVE THE COMPLETED CONTRACT METHOD

Mr. SCHNEIDER. My name is Leslie J. Schneider. I am an attorney with the Washington, D.C. law firm of Ivins, Phillips & Barker. In addition, I aided in the development of the long-term contract, advance payment, and inventory regulations when I was employed by the Treasury Department in the early 1970's. I am testifying today in my capacity as counsel to a newly formed organization, entitled the "Committee To Preserve the Completed Contract Method."

Our committee was organized to represent the interests of a number of companies in such diversified areas as shipbuilding, scientific, and precision instruments, defense, aerospace, and commercial, industrial, and residential construction.

Each of these industries is adversely and significantly affected by the Treasury proposals.

I have a longer statement for the record, which I will furnish and I would like to just summarize my comments.

In the President's state of the Union message on January 26, 1982, the President indicated that the administration was committed to its tax cut program and would not embark on a goal of fundamental tax increases. Instead, the administration announced that it would concentrate its tax reform effort "to eliminate abuses and to remove obsolete incentives."

It was in this regard that various proposals were made with regard to the completed contract method.

The Treasury Department indicated that it perceived that there are two major abuses in the completed contract method. The first is that in some instances, companies are leaving contracts open indefinitely and failing to close the contracts by manipulating various options in and various extensions of the contract.

Second, the Treasury Department indicated that various companies were perhaps deducting more expenses currently than they were really entitled to deduct, whereas they should be deferring those expenses until the contract was completed under the completed contract method.

It seems to us, that if one believes that those types of abuses are widespread and that they are in fact abuses, it would be very easy and very simple to take care of those two kinds of problems. Various revenue rulings could be issued and the regulations, if necessary, could be tightened and clarified to take care of those problems in a very simple manner and eliminate the abuses that the Treasury perceives.

On the other hand, what Treasury had done instead of choosing to follow that route, is to embark on an across-the-board basis repeal of one, the completed contract method; two, the accrual method of accounting for long-term contracts; and three, the cash method of accounting.

We think that that is clearly a case of overkill, especially when you compare it to the types of abuses that the Treasury alleges.

The completed contract method has been in the law for over 60 years. It has been reconsidered on numerous occasions, and it has been found to clearly reflect income and to be a proper method of tax accounting. This has some bearing, for example, on the question that came up in last Saturday's article in the Washington Post. A number of allegations were made comparing taxpayers' earnings under the completed contract method with what perhaps they would have been under the accrual method or percentage of completion method that was being used for financial accounting. The article cites various statistics of the difference in income that would have been reported under those two methods and suggested that such difference is the amount of revenue that is going by the boards by virtue of allowing companies to use the completed contract method.

There is a very fundamental assumption, I think, that has to be understood when one reads between the lines of that argument, and that assumption is that the method of accounting that those taxpayers use for financial accounting should have been used for tax purposes and would clearly reflect income for tax purposes.

I think, as Mr. Bushman indicated, one must recognize that there is a divergency of interest between tax and financial accounting. Let me give as a simple example the case of a taxpayer who would be on the ordinary accrual method. You could argue that he has nothing whatever to do with construction or the completed contract method. Let's assume you were going out this weekend and wanted to order some furniture. You went to the furniture store and ordered furniture that the manufacturer had to manufacture and did not have in inventory. As is customary in the industry, you might be required to give him a downpayment of 50 percent of the purchase price.

The taxpayer in that case might take 6 months, 9 months, or 1 year to complete that furniture. In no event, under the accrual method under existing law, would that furniture manufacturer be required to report that deposit that you made to him in his income currently.

In no event would he be allowed to deduct every single expense of operating his business while he was manufacturing that furniture. You would not say that if his taxable year ended in the middle of the manufacture of that furniture that somehow he had earned 50 percent of the profit on that furniture merely because that is where the taxable year ended.

Similarly, if a construction taxpayer were to build an office building and at the end of the year completed one floor of a 10-story building, it would not be fair at all and would not clearly be in accord with tax accounting principles to say that he had earned and realized one-tenth of the profit on that contract.

We think it is this fundamental notion that underlies the entire argument in the area and underlies the concepts developed in the Washington Post article, that is, that somehow the percentage of completion method or the method that is being reported for financial purposes is the best method of reporting and ought to be the method of accounting used for tax purposes.

I think it is clear in every other industry this is the method of accounting that would be used for tax purposes and this industry should not be the exception.

In conclusion, I think I would merely summarize by saying that the construction industry and all the other industries that are affected by these proposals believe that the present tax rules are the proper rules, they are the rules every other industry is governed by in reporting their incomes and expenses, and to the extent any abuses do exist in this area, they are attributable to the lack of guidance provided by the Service and lack of clear rules that could easily be clarified and corrected without repealing the completed contract method, repealing the accrual method and repealing the cash method.

[The prepared statement follows:]

STATEMENT OF THE COMMITTEE TO PRESERVE COMPLETED CONTRACT METHOD

SUMMARY OF TESTIMONY

1. The present rules for accounting for long-term contracts have been a part of our tax laws for over 60 years. These provisions were adopted after careful consideration and after consultations with members of Congress and their staffs, and these provisions have never been viewed as providing an unintended loophole;

2. The tax accounting rules which apply to taxpayers with long-term contracts are comparable to those which apply to most other taxpayers. The Administration's proposals would drastically alter such symmetry; and

3. The particular abuses which the Administration seeks to redress could easily be resolved under the existing law by more effective audit enforcement and by the promulgation of clarifying revenue rulings which interpret the present law. The Administration's proposals represent a classic case of overkill, by eliminating the entire body of statutory, regulatory and judicial law developed over the past 60 years.

STATEMENT

My name is Leslie J. Schneider. I am an attorney with the Washington, D.C. law firm of Ivins, Phillips & Barker. In addition, I aided in the development of the long-term contract, advance payment and inventory regulations when I was employed by the Treasury Department in the early 1970's. I am testifying today in my capacity as counsel to a newly-formed organization, entitled the "Committee to Preserve the Completed Contract Method."

Our committee was organized to represent the interests of a number of companies in such diversified areas as shipbuilding, scientific and precision instruments, defense, aerospace, and commercial, industrial and residential construction. The principal goal of the committee is to present a unified view of the full range of companies that will be adversely affected by the Administration's proposals to drastically alter the tax accounting rules for long-term contracts.

In the President's State of the Union Message on January 26, 1982, the President indicated that the Administration was committed to its tax cut program and would not embark on a goal of fundamental tax increases. Instead, the Administration announced that it would concentrate its tax reform effort "to eliminate abuses and to remove obsolete incentives." It is in this context that the Administration has proposed the total elimination of the completed contract method, as well as the traditional accrual method of tax accounting, for long-term contract, and to incorporate certain period costs on existing long-term contracts as a tax preference item in the new proposed minimum tax on corporations.

The committee is unequivocally opposed to the Administration's long-term contract proposals. The Administration's explanation of the proposals inaccurately portrays the present tax accounting rules for taxpayers with long-term contracts as a loophole. Furthermore, the Administration's proposals would unfairly discriminate against such taxpayers.

Thus, the thrust of the committee's testimony today is as follows:

(1) The present rules for accounting for long-term contracts have been a part of our tax laws for over 60 years. These provisions were adopted after careful consider-

ation and after consultations with members of Congress and their staffs, and these provisions have never been viewed as providing an unintended loophole;

(2) The tax accounting rules which apply to taxpayers with long-term contracts are comparable to those which apply to most other taxpayers. The Administration's proposals would drastically alter such symmetry; and

(3) The particular abuses which the Administration seeks to redress could easily be resolved under the existing law by more effective audit enforcement and by the promulgation of clarifying revenue rulings which interpret the present law. The Administration's proposals represent a classic case of overkill, by eliminating the entire body of statutory, regulatory and judicial law developed over the past 60 years.

I. HISTORICAL BACKGROUND

For over 60 years, taxpayers having long-term building, installation or construction contracts have been able to use either of two specialized methods of accounting—the completed contract method and the percentage of completion method. In addition, such taxpayers have also been permitted to use the traditional methods of accounting otherwise available to all taxpayers, i.e., the cash and accrual methods.

The Internal Revenue Service indicated that the principal reason why specialized methods of accounting have been permitted to be used in reporting income from long-term contracts is that the economic outcome of such types of contracts is inherently unpredictable. Such unpredictability results from the extended term of the typical long-term contract and because long-term contract activities are often influenced by uncontrollable factors, such as weather, strikes, material shortages, technological changes, and the uniqueness of each construction project.

It is recognized that an important feature of our tax laws is that the reporting of income and expenses is required when the amount thereof is determinable with reasonable accuracy. In the case of long-term contracts, such determination must necessarily await the completion of each contract. Thus, the need for a specialized method of accounting—the completed contract method—was firmly established.

Some ten years ago, an attempt was made to restrict the use of the completed contract method for tax purposes to instances where that method was also used for financial reporting purposes. Although that proposal was not nearly as radical as the present Administration's proposal, the Treasury, after considerable discussion with taxpayers affected by these proposed changes and with the Congress, reconsidered its approach and abandoned its effort to restrict the use of the completed contract method.

One issue that long existed under the long-term contract method of accounting was the question of eligibility. In particular, the definition of taxpayers eligible to use the long-term contract method contained in the regulations for many years was limited to taxpayers engaged in "building, installation or construction." Questions were raised as to whether such definition could include the manufacture of unique, large scale pieces of equipment, such as aircraft. Both the Internal Revenue Service and the courts agreed that such activities were indistinguishable from the activities qualifying for completed contract method reporting under the regulations and, therefore, would be eligible for such reporting. The long-term contract regulations were specifically amended in 1976 to clarify that this type of manufacturing activity would be eligible for long-term contract reporting. In contrast, the Internal Revenue Service has rigidly controlled access to the long-term contract methods to eligible taxpayers.

In conclusion, the present availability of the long-term contract methods and the categories of taxpayers who are eligible to use such methods were carefully thought out and have evolved over a 60-year period. There has been no unintended use of these methods. The rules were specifically rewritten several times, with careful review and consultation with Congress over a five-year period from 1970 to 1975, and everyone accepted the outcome as appropriate.

II. SYMMETRY OF METHODS OF ACCOUNTING

The second assumption underlying the Administration's proposals in this area is that not only is the use of the completed contract or accrual method an unintended loophole, but that the operation of such methods distorts income and produces unfair results to the disadvantage of the Treasury. The committee contends that such assumption is untrue and that there is a perfectly logical symmetry between the present accounting rules for long-term contracts and those that apply to all other taxpayers. An analysis of this premise is quite technical in nature and requires a careful evaluation of the operation of all traditional accounting methods,

including the completed contract method. The committee has undertaken such an effort and will submit for the record its detailed memorandum on this point. Suffice it to say that, in general, the completed contract method produces results comparable to other methods of accounting available to all taxpayers.

The Administration has made much of the fact that under the completed contract method while all revenues may be deferred until the completion of the contract, many expenses may be deducted currently, possibly creating an artificial loss. In fact, under the completed contract method, expenses related to construction must be deferred until contract completion, just as revenues are deferred. The expenses that may be deducted currently are those that are very general in nature and that are deductible by any operating business under the accrual method. Under the accrual method, production-related expenses are deferred in an inventory account until the construction is completed and the property is delivered to the customer. However, expenses which are general in nature would be currently deductible in the same manner as under the completed contract method. Furthermore, taxpayers using the accrual method are eligible to use liberal inventory valuation methods. It is the Treasury's position that taxpayers using the completed contract method are precluded from using such liberal methods.

In conclusion, the tax accounting rules for taxpayers with long-term contracts are fair and clearly reflect income.

III. EVALUATION OF ADMINISTRATION PROPOSALS

In view of the logic and symmetry of the existing long-term contract rules and in view of their 60 year history, the question which you should be addressing is why the Administration is now proposing such a drastic revision of the present rules. Let us focus on the reasons which the Administration offers as support for its proposals.

First, the Administration alleges that some companies have utilized either change orders to contracts or supplemental maintenance agreements as a means of indefinitely extending a long-term contract, so that 10 or 20 years elapse before any income is reported. Second, the Administration asserts that in some cases the allowance of certain period costs on current contracts exceeds revenues reported on older completed contracts, thereby creating artificial losses. The Administration claims that these aberrations occur under the accrual method, as well as under the completed contract method. Finally, the Administration notes that in at least one case a company has used the foregoing accounting rules to eliminate earnings and profits and pay out tax-free dividends to shareholders. In summary, the alleged evils are indefinite deferral of contract completions, excessive deduction of certain period costs, and the payment of "tax-free" dividends.

In each of the foregoing instances, the committee believes that the present regulations already provide ample legal authority to challenge the foregoing practices where they appear to be abusive. In particular, what is necessary to resolve these problems is the combination of more effective audits to deal with abusive practices and the publication of guidance in areas where the specific rules are not sufficiently detailed. With such a program, the Internal Revenue Service could easily use the existing regulations to eliminate the types of abuses which the Administration perceives.

However, in lieu of adopting a reasonable program to deal with the alleged problems, the Administration has adopted a shotgun approach. The Administration would ignore 60 years of precedent and repeal the completed contract method, the accrual method and the cash method of accounting for long-term contracts. The Administration would thus penalize all taxpayers with long-term contracts, including the vast majority of taxpayers who have never been faced with the issues that concern the Administration. Enactment of such proposals would create an enormous and unfair disparity between long-term contractors on the one hand and the balance of American commerce on the other. Taxpayers other than those with long-term contracts would be able to continue to use the cash or accrual method of accounting, would continue to defer progress payments, would continue to use liberal inventory valuation methods, including the lower of cost or market method and the LIFO method. The committee fails to understand how such discrimination against taxpayers with long-term contracts can be justified by the Administration.

The Administration's proposed alternative methods offer no solace. The Administration acknowledges that the percentage of completion method is an impractical method that is based on inaccurate estimates. Alternatively, the newly proposed progress payment method is a one way street which concentrates on cash flow, a measure often wholly unrelated to profit or loss, and ignores the economic risks

which are inherent under long-term contracts. In conclusion, you must reject the Administration's legislative proposals in their entirety.

Congress should not be satisfied with mere rejection of the Administration's legislative proposals. Congress must go further and prevent the Treasury from amending the regulations to drastically alter the costing rules that apply to long-term contracts. The Treasury's approach would eliminate the deduction of expenses that would be deductible by all taxpayers not having long-term contracts. In fact, the reason that the present regulations permit such a deduction is that such treatment is parallel to that available in all other industries. This treatment is not a subsidy to the construction industry and it should not be eliminated.

In conclusion, if there is a message to be sent, it should be to the Internal Revenue Service directing that Agency to conduct more effective audits. Using the existing rules, there is an ample opportunity to eliminate the abuses which the Administration claims exist.

Thank you for your consideration.

Technical Memorandum

My name is Leslie J. Schneider. I am an attorney with the Washington, D.C. law firm of Ivins, Phillips & Barker. I am the author of the treatise, Federal Income Taxation of Inventories (3 Vols. Matthew Bender) and numerous articles and publications dealing with tax accounting matters and long-term contracts. I have also been an Adjunct Professor of Federal Tax Accounting in Georgetown University Law Center's Master of Taxation program.

Prior to joining Ivins, Phillips & Barker in 1973, I was an attorney and accountant adviser in the Office of Tax Legislative Counsel. I was one of the principal draftsmen of the long-term contract regulations (Reg. § 1.451-3), advance payment regulations (Reg. § 1.451-5), and the full absorption inventory regulations (Reg. § 1.471-11).

I am testifying in my capacity as Counsel to a newly-formed organization, entitled the "Committee to Preserve the Completed Contract Method." Accompanying me is Michael F. Solomon, Assistant Counsel.

The committee consists of a number of companies in such diversified areas as shipbuilding, scientific and precision instruments, defense, aerospace, and commercial, industrial and residential construction. The principal goal of the committee is to present the view of the full range of companies that will be adversely affected by the Administration's proposals to drastically alter the tax accounting rules for long-term contracts.

I. INTRODUCTION

In the President's State of the Union Message on January 26, 1982, the President indicated that the Administration was committed to the tax cut program enacted by the Congress as part of the Economic Recovery Tax Act of 1981. The President stated that his Administration would not pursue a broad-based effort to raise taxes; instead, the Administration is on record that it will concentrate its tax reform effort "to eliminate abuses and to remove obsolete incentives." It is in this context that the Administration has proposed the total elimination of the completed contract method, as well as the traditional accrual method of accounting, for long-term contracts and to incorporate certain period costs on existing long-term contracts as a tax preference item in the new proposed minimum tax on corporations.

The committee is unequivocally opposed to the Administration's long-term contract proposals. The Administration's explanation of the proposals inaccurately portray the present tax accounting rules for taxpayers with long-term contracts as an unintended loophole. Furthermore, the Administration's proposals would unfairly discriminate against taxpayers with long-term contracts by placing them in a less competitive position than taxpayers without long-term contracts in other industries.

The central thesis of the committee's testimony is that:

(1) The present rules of accounting for long-term contracts have been a part of our tax laws for over 60 years. These provisions were adopted after careful consideration and after consultations with members of Congress and their staffs, and do not provide an unintended loophole;

(2) The tax accounting rules which apply to taxpayers with long-term contracts are comparable to those which apply to most other taxpayers. The Administration's proposals would drastically alter such symmetry; and

(3) The particular abuses which the Administration seeks to redress could easily be resolved under the existing law by more effective audit enforcement and by the promulgation of clarifying revenue rulings which interpret the present law. The Ad-

ministration's proposals represent a classic case of overkill, by eliminating the entire body of statutory, regulatory and judicial law developed over the past 60 years.

The subject of tax accounting is technical and complex. In order to have a complete understanding of this subject and in order to properly evaluate the Administration's proposals, it is essential to place the present tax accounting rules for long-term contracts in their historical perspective. Accordingly, this technical memorandum sets forth below a detailed analysis of the historical development of the present tax accounting rules for long-term contracts. In addition, the various reasons why the Administration's proposal in this area should not be adopted are further developed in subsequent sections of this memorandum.

II. HISTORICAL DEVELOPMENT OF THE COMPLETED CONTRACT METHOD

In regulations dating back to 1918, the Internal Revenue Service has permitted two specialized methods of accounting to be used for long-term contracts: (1) the completed contract method; and (2) the percentage of completion method. Article 121, Reg. § 33 (1918) provided for the reporting of income by contracting corporations as follows:

"Art. 121. Contracting corporations.—Corporations engaged in contracting operations and which have numerous uncompleted contracts, which in some cases run for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work—that is, on jobs which have been finally completed—any and all moneys received in payment for completed jobs will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from gross income should be limited to the expenditures made on account of such completed contracts.

"Income on basis of estimates.—Or the percentage of profit from the contract may be estimated on the basis of percentage of completion and payments made thereon, in which case the income to be returned each year during the performance of the contract will be computed upon the basis of the expenses incurred on such contract during the year; that is to say, if one-half of the estimated expenses necessary to the full performance of the contract are incurred during one year, one-half of the gross contract price should be returned as income for that year; all under or overstatements of income to be adjusted upon completion of the contract and return made accordingly. (T.D. 2161.)

"In cases wherein contracts are fully performed in one year, although payment therefor may be deferred until the next, the income resulting from the performance of the contract shall be returned for the year in which it was actually earned and determined."

The availability of these specialized methods of accounting have also received the support of the courts. See *Ehret-Day* v. *Comm.*, 2 T.C. 25 (1943); *Rice, Barton & Fales, Inc.* v. *Comm.*, 41 F. 2d 339 (1st Cir. 1930); *Badgley* v. *Comm.*, 21 BTA 1055 (1931), aff'd 59 F. 2d 203 (2nd Cir. 1932); and *James C. Ellis* v. *Comm.*, 16 BTA 1225, wherein the Board stated:

"But the petitioners say that the article just quoted is invalid, since it permits a taxpayer to report on a basis that does not fairly reflect his income, and that, therefore, an election made under authority of the article is not binding. We cannot agree with that argument. It is true that returning income on the completed contract basis may result in a larger income in a given year than would be reported for the same year were the profit spread over the entire term in which the contract was performed. But it seems to us that the former method of returning the profit from a long-term contract is no more likely to result in distortion of income than the latter method. For example, a contract covering a period of two years may show a profit at the end of the first year based on receipts and expenditures at that time, whereas the contract when completed may result in a loss. The completed contract basis will always reflect the gain or loss from the contract as a whole, while the other method may result in a gain being reported in one year when the contract terminates in a loss, or a loss being reported when a gain finally is realized. The regulation in question is designed to reflect income from long-term contracts, and we are unable to perceive that it is inconsistent with or is not authorized by law. *In re Harrington*, 1 Fed. (2d) 749." 16 BTA at 1228.

The specialized long-term contract methods are not, however, mandatory. Thus, taxpayers with long-term contracts are permitted to use the accrual method and, in some cases, the cash method. *See* Reg. § 1.451-3; G.C.M. 22682, 1941-1 C. B. 307; and *C. A. Hunt Engineering Co., Inc.* v. *Comm.*, 15 T.C.M. 1269 (1956).

Under the completed contract method, no revenues or expenses directly related to a long-term contract are included in taxable income until the contract is finally completed and accepted. Reg. § 1.451-3(b)(2). Under the percentage of completion method, the expenses of performing the long-term contract are currently deductible and that portion of the contract price reflected by the percentage of the contract which is completed during the taxable year must be included currently in gross reveneus. Reg. § 1.451-3(c). Under both of these methods, progress payments received prior to the completion of the contract do not enter into the determination of any such taxpayer's taxable income. Reg. § 1.451-5(b)(3); Reg. § 1.451-3(c); Reg. § 1.451-3(d)(1).

In practice, the completed contract method has proved to be the more prevalent method. It enables taxpayers with long-term contracts to conserve working capital during the construction period and produces a precise matching of revenues and expenses and a corresponding determination of taxable income directly attributable to each long-term contract. The rationale for the availability of such method has been explained by the Internal Revenue Service as follows:

"One of the reasons why permission to report on a completed contract basis is given * * * is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay and unexpected difficulties in laying foundations which make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed." Rev. Rul. 70-67, 1970-1 C.B. 117.

The present regulations dealing with long-term contract accounting were adopted in 1976. See T.D. 7397, January 16, 1976. These regulations were an outgrowth of a Treasury study of the tax accounting area that commenced in 1969 and was itself a response to the tax problems that arose in connection with the taxation of prepaid income. During the late 1950's and early 1960's, a series of cases dealing with the taxation of prepaid income attributable to the future performance of services reached the Supreme Court. See *Schlude* v. *Comm.*, 372 U.S. 128 (1963); *American Automobile Association* v. *U.S.*, 367 U.S. 687 (1961); and *Automobile Club of Michigan* v. *Comm.*, 353 U.S. 180 (1957).

In each of these cases, the Court ruled that the accrual basis taxpayer involved therein was required to include the prepayments in gross income in the year of receipt. each of these cases involved a taxpayer performing services, and thus, each taxpayer lacked any inventory and deducted all expenses associated with the particular business as they were incurred. Notwithstanding that these cases were limited to service taxpayers, there was great concern among manufacturers and contractors that the conclusion reached in these three decisions would be extended to manufacturers who received prepayments for goods in the course of production and to contractors who received progress payments during the course of construction. This concern was greatly heightened by the decision in *Hagen Advertising Displays, Inc.* v. *Comm.*, 407 F. 2d 1105 (6th Cir. 1969), where the Sixth Circuit held that the prepaid income doctrine was equally applicable to taxpayers engaged in the production and sale of goods.

In 1970, President Nixon's Task Force on Business Taxation recommended that there be closer conformity between tax and financial accounting. The Task Force was particularly disturbed by the dispairty between tax and financial reporting of prepaid income. While prepaid income is not, and was not then, included in income for financial purposes until the prepayments are "earned" through the performance of services or the sale of goods, the accounting profession generally accelerates the reporting of both income and expense under long-term contracts as compared to the tax treatment afforded such contracts because of the accounting profession's preference for the use of the percentage of completion method. In response to the Task Force's concerns in this area, the Treasury embarked on a program to promote greater conformity between tax and financial reporting. The Treasury initiated such program with the publication of regulations to permit the deferral of prepaid income received by accrual basis manufacturers until such prepaid income is earned through the completion and delivery of the goods. Reg. § 1.451-5(b). However, as a condition to deferring such prepayments for tax purposes, taxpayers, were required to defer such prepayments for financial reporting purposes. Reg. § 1.451-5(b)(1)(ii).

The resolution of the prepaid income problem for accrual basis manufacturers left open the problem of taxing progress payments received by taxpayers reporting income on a long-term contract basis. However, the Treasury initially believed that equity dictated that such taxpayers should also be permitted to defer the inclusion of progress payments in gross income for tax purposes provided that the progress payments were accorded conforming treatment for financial reporting purposes.

Thus, proposed regulations were issued to provide that a taxpayer could use the completed contract method for tax purposes only if it used such method for financial reporting purposes. Prop. Reg. § 1.451-3(e)(1) (March 24, 1971).

The Treasury's proposal met with considerable opposition, not only from the construction and building industries, but also from numerous members of Congress. Letters and comments submitted by senators and congressmen indicated that Congress was uniformly opposed to the imposition of restictions on the use of the completed contract method for tax purposes. The criticisms emanating from Congress were fairly unanimous in their assertion that a financial conformity requirement in this area was tantamount to an outright ban on the use of the completed contract method for tax purposes because the accounting profession generally required that the percentage of completion method be used for financial reporting of income from long-term contracts. Congress recognized that there is a genuine difference between tax and financial reporting, relfected in disparate goals and differing attitudes towards the use of estimates to reflect revenue recognition.

In the final analysis, and after a considerable period of studying the problems, Treasury agreed to eliminate any financial reporting restrictions on the use of the completed contract method. Proposed regulations were issued in 1972 and final regulations were adopted in 1976 reflecting this position. T.D. 7397, January 16, 1976. In abandoning the financial conformity requirement and otherwise eliminating all proposed restrictions on the use of the completed contract method, the Treasury was convinced that the completed contract method clearly reflected the income of taxpayers with long-term contracts.

Although Treasury began its review of the completed contract method in the early 1970's with a view to making substantive modifications to the rules, the 1976 Treasury Decision adopting the final regulations did little more than to clarify certain ambiguities in the areas of eligibility and costing that had existed under the prior rules.

Under the prior long-term contract regulations, manufacturing contracts were not expressly included in the definition of long-term contracts. Reg. § 1.451-3(a) (1957). Nevertheless, certain manufacturers of large equipment had long been permitted to use the completed contract method of accounting as a result of favorable judicial precedents. See e.g. *Rice, Barton & Fales, Inc.* v. *Comm.*, 41 F. 2d 339 (1st Cir. 1930); and *Grays Harbor Motorship Corp.* v. *U.S.*, 45 F. 2d 259 (Ct. Cl. 1930). However, the courts had prohibited taxpayers from using the special long-term contract methods for the sale of property for delivery more than one year after the signing of the contract (*Nona B. Wood* v. *Comm.* 14 T.C.M. 1156 (1955), aff'd this issue 245 F. 2d 888 (5th Cir. 1957)); for contracts for the sale of lumber (*C. H. Swift & Sons* v. *Comm.*, 13 B.T.A. 138 (1928)); for oil brokerage contracts requiring delivery more than one year in the future (*Lakeside Petroleum Co.* v. *U.S.*, 1 F. Supp. 31 (E.D. Ill. 1932)); and for contracts for the breeding of animals (*Est. of B. F. Whitaker* v. *Comm.*, 259 F. 2d 379 (5th Cir. 1958)). The courts had apparently distinguished between general merchandising contracts and those calling for either building, installation or construction.

The 1976 regulations clarified which types of manufacturing contracts qualified for the special long-term contract methoods. Manufacturing contracts only qualify if they involve the manufacture of: (1) unique items of a type which are not normally carried in the finished goods inventory of the taxpayer; or (2) items which normally require more than 12 calendar months to complete, regardless of the duration of the actual contract. Reg. § 1.451-3(b)(1).

The 1987 regulations specifically did not liberalize the eligibility rules to include architects, engineers and the like. The Internal Revenue Service had long excluded these taxpayers from using these special methods. See Rev. Rul. 70-67, 1970-1 C.B. 117.

With respect to the treatment of costs by taxpayers using the completed contract method of accounting, the 1976 regulations contained detailed rules where limited rules had previously been. Under the prior regulations, very few rules were provided to deal with the problems of costing under long-term contracts. See e.g. A.R.R. 8367, III-2 C.B. 57, declared obsolete by Rev. Rul. 67-123, 1967-1 C.B. 383; *Edward Lane* v. *Comm.*, 37 T.C. 188 (1961). In general, these prior rules required the deferral of both direct and indirect costs attributable to the long-term contracts in progress.

The new regulations continued the same basic policy of deferring direct and indirect costs attributable to particular long-term contracts, but provided detailed rules for determining which costs (direct and indirect) are incident to and necessary for the performance of particular long-term contracts. Reg. § 1.451-3(d)(5). These rules are discussed in greater detail in section III herein. They basically conformed the

allocation of costs under long-term contracts to other tax accounting areas and greatly clarified uncertainties existing under the prior rules.

The 1976 amendments to the regulations were designed to bring greater certainty in this area of tax accounting. The rules were not materially changed nor liberalized. This committee cannot accept the Treasury's effort at this time in light of the considerable effort just a few years ago to review this entire area of tax accounting.

III. THE COMPLETED CONTRACT METHOD IS CONSISTENT WITH TRADITIONAL TAX ACCOUNTING PRINCIPLES GOVERNING PROFIT AND LOSS RECOGNITION

A fundamental assumption underlying the Administration's proposals to repeal the completed contract and accrual methods of accounting for long-term contracts is that tax-payers using such methods obtain certain unintended benefits or an unfair advantage over other taxpayers reporting profit or loss under generally applicable methods of accounting. The committee contends that this assumption is incorrect and is due to the Treasury's failure to fully comprehend the historical relationship among the various methods of accounting. The committee maintains that when the tax accounting rules underlying the completed contract method are compared to the tax accounting principles that apply to taxpayers not performing long-term contracts, it is apparent that the methods are roughly comparable and do not confer unfair advantages on taxpayers performing long-term contracts.

Taxpayers engaged in the manufacture or construction of a product are ordinarily required to maintain inventories and to use the accrual method of accounting. See Reg. § 1.446-1(a)(4)(i); Reg. § 1.446-1(c)(2)(i); and Reg. § 1.471-1. Pursuant to these requirements, a taxpayer manufacturing or constructing a product would accumulate the costs incurred incident to and necessary for the manufacturing or construction activities until the related product is shipped, delivered, or accepted, depending on the taxpayer's regular method of accounting and would be offset against the contract price which would be includible in gross receipts at such time. See Reg. § 1.446-1(c)(1)(ii).

Pursuant to the accrual method of accounting, revenue is included in a taxpayer's gross income in the taxable year in which all events have occurred which fix the right to receive the revenue and the amount thereof can be determined with reasonable accuracy. See Reg. § 1.451-1(a); *Spring City Foundry Co.* v. *Comm.*, 292 U.S. 182 (1934). As noted above, ordinarily, revenue is included in income when the manufacturer or contractor ships or delivers the product or such product is accepted by the purchaser, depending on the taxpayer's regular method of accounting in this regard. Under such general rule, the time when a particular taxpayer either bills the customer for the sale of the product or he actually receives payment for the product is irrelevant for accrual purposes.

In contrast to the foregoing general rule, a question arises as to the proper time for reporting income amounts received in advance of the shipment, delivery or acceptance of the product. Advance payments or progress payments are, by definition, amounts received by an accrual-basis taxpayer in advance of the time when such amounts would be properly accruable under the "all events test" noted above. Because it was generally perceived that such advance payments or progress payments had many characteristics of loans *(Consolidated-Hammer Dry Plate & Film Co.* v. *Comm.*, 317 F. 2d 829 (7th Cir. 1963)), it had always been assumed that the receipt of progress payments would be ignored for tax purposes and that these amounts should be included in income at the time they would ordinarily be included in income under the taxpayer's regular accrual method (i.e., at the time of shipment, delivery or acceptance). However, following a series of Supreme Court cases dealing with prepaid income received by taxpayers performing services, one court extended the prepaid income doctrine to the sale of goods and held that such prepayments were currently taxable. *See Hagen Advertising Displays, Inc.* v. *Comm.*, 107 F. 2d 1105 (6th Cir. 1969). Following this decision, the Treasury reconsidered the widom of taxing prepaid income which is nothing more than a form of financing. As a result, the Treasury issued regulations permitting prepaid income to be deferred pursuant to the taxpayer's regular method of accounting. See Reg. § 1.451-5.

With respect to the treatment of expenses by an accrual basic taxpayer engaged in the manufacture or construction of a product, as noted above, the direct and indirect costs incurred incident to and necessary for the production of the product would be deferred until the product is shipped, delivered or accepted. Such deferred costs would be carried in an inventory account and could be valued at either costs or the lower of cost or market. (See Reg. § 1.471-2(c). Thus, during the course of the production of the product, if it became apparent that the costs of production would exceed the contract price for the goods, the taxpayer would be entitled to deduct

currently the amount of the such ultimate loss, even prior to the actual completion and sale of the product. This would be true even if initial learning curves caused the cost of production of the first unit under a contract to be significantly higher than the costs of producing subsequent units in a multi-unit contract. See Reg. § 1.471-4; *Space Controls, Inc.* v. *Comm.*, 322 F. 2d 144 (5th Cir. 1963); *E.W. Bliss Co.* v. *U.S.*, 351 F. 2d 449 (6th Cir. 1965). Alternatively, a taxpayer could elect to use an equally liberal method of inventory valuation—the LIFO method. See IRC § 472. Pursuant to such methods, the taxpayer could eliminate from its inventory and deduct currently the inflation in the cost of such product.

Finally, with respect to the determination of the inventory cost of such product, a taxpayer manufacturing or constructing a product would be required to use the full absorption method of inventory costing. Under such method, all direct production costs and certain indirect production costs must be includible in inventoriable costs of tax purposes. See Reg. § 1.471-11(c)(2)(i). In contract, certain indirect costs are permitted to be expensed as period costs for tax purposes. See Reg. § 1.471-11(c)(2)(ii). A third category of indirect production costs, which contains most of the large overhead costs (i.e., property taxes, depreciation, fringe benefits, and factory administrative costs), are includible in or excludible from investory for tax purposes depending on their treatment in the taxpayer's financial statements. See Reg. § 1.471-11(c)(2)(iii). This three-category approach is quite flexible and enables most accrual-method taxpayers to deduct as a period cost a significant portion of their regular operating expenses. Where an accrual-basis taxpayer uses completely different overall methods of accounting for tax and financial reporting purposes, the third category noted above is eliminated in the regulations, with some of the costs assigned to inventory and the balance assigned to period costs. See Reg. § 1.471-11(c)(3). This treatment is virtually identical to that accorded to taxpayers employing the completed contract method.

For taxpayers manufacturing or constructing a product under a long-term contract, the completed contract method of accounting provides the same basic framework of revenue recognition and cost accumulation as is found under the traditional accrual method. Under the completed contract method, contract revenue is included in income in the taxable year in which the contract is completed and accepted, which is comparable to the time of revenue recognition under the accrual method (i.e., the date of shipment, delivery or acceptance of a product). Progress payments under the completed contract methods are also ignored to the same extent as under the accrual method.

With respect to the treatment of expenses, contract costs under the completed contract method are accumulated and allowed as an offsetting deduction when contract revenues are taken into income upon the completion of the contract. Reg. § 1.451-3(d). In applying such rule, certain indirect costs are permitted to be deducted currently. These rules directly parallel the treatment afforded an accrual-basis taxpayer.

However, the costing rules applicable to taxpayers using the completed contract method are disadvantageous in one significant respect. The Internal Revenue Service takes the position that the accumulated contract costs under the completed contract method are not inventoriable costs. See Rev. Rul. 59-329, 1959-2 C.B. 138. Accordingly, under the Service's view, these costs are not eligible for either the lower of cost or market method nor for the special LIFO ordering rules.

The Administration alleges that the completed contract method contains a significant loophole, i.e., the ability of taxpayers to deduct currently certain indirect costs, while deferring all contract revenues until completion of the contract. However, as noted above, all accrual-method taxpayers may deduct certain indirect costs even if such costs are related to the manufacture or construction of a product that remains in inventory. Moreover, when one compares the range of costs which are currently deductible under the completed contract method with those period costs deductible under the full absorption inventory rules applicable to manufacturers, it is quite apparent that the latter group of taxpayers have greater flexibility than taxpayers using the completed contract method. For example, all of the indirect costs that must be inventoried for tax purposes on the one hand, and all of the indirect costs that may be excluded from inventory for tax purposes on the other hand, are identical to the costs that must be deferred or are deductible under the completed contract method. Compare Reg. § 1.471-11(c)(2) (i) and (ii) with Reg. § 1.451-3(d) (ii) and (iii). In contrast, while the balance of the indirect cost may either be inventories or not at the option of the accrual-basis taxpayer based on his financial statement treatment of such costs, all of such costs except fringe benefit costs and the cost of strikes, etc. must be deferred under the completed contract method. Accordingly, contrary to the Administration's assertions, taxpayers not using the completed con-

tract method may be, and in fact are, generally expensing a greater proportion of operating expenses than taxpayers using the completed contract method. When this fact is combined with the unavailability of the lower of cost or market method and LIFO method for taxpayers using the completed contract method, it is difficult to perceive that the Administration views such method as abusive when compared to the traditional accrual method available to all taxpayers, including those having long-term contracts and those without such business.

IV. EVALUATION OF ADMINISTRATION PROPOSALS

A. Alleged abuses

In view of the consistency of the existing long-term contract rules with the more general tax accounting policies regarding revenue recognition and costs and in view of their 60 year history, the question which must be addressed is why this Administration is now proposing such a drastic revision of the present rules. Let us focus on the reasons which the Administration offers as support for its proposals.

First, the Administration alleges that some companies have utilized either change orders to contracts or supplemental maintenance agreements as a means of indefinitely extending a long-term contract, so that 10 or 20 years elapse before any income is reported. Second, the Administration asserts that in some cases the allowance of certain period costs on current contracts exceeds revenues reported on older completed contracts, thereby creating artificial losses. The Administration claims that these aberations occur under the accrual method, as well as under the completed method. Finally, the Administration notes that in at least one case a company has used the foregoing tax accounting rules to eliminate earnings and profits and pay out "tax-free" dividents to shareholders. In summery, the alleged evils are indefinite deferral of contract completions, excessive deduction of certain period costs, and the payment of "tax-free" dividends.

In each of the foregoing instances, the committee submits that the present regulations already provide ample legal authority to challenge the foregoing practices where they appear to be abusive.

1. *Deferral of contract completions.* With respect to the problem of open-ended completion dates, the current regulations contain a number of provisions designed to combat abuses in this area. The current long-term contract regulations provide that under the completed contract method, the contract price is not includible in a contractor's gross income until the contract is finally completed and accepted (Reg. § 1.451-3(b)(2)). The regulations, however, also state that, "a taxpayer may not delay the completion of a contract for the principal purpose of deferring Federal income tax." Reg. § 1.451-3(b)(2). This provision enables the Internal Revenue Service to treat a contract as completed where relatively minor amounts of work under the contract are purposefully delayed in order to prevent contract closing.

A second provision available to the Internal Revenue Service to combat the problem of indefinite deferral is covered under the "dispute" rules. Prior to the adoption of the current long-term contract regulations the existence of any dispute between a long-term contract taxpayer and customer, regardless of how minor, held the contract open indefinitely. *Irwin* v. *Comm.*, 238 F. 2d 874 (3rd Cir. 1956); *C. H. Leavell* v. *Comm.*, 53 T.C. 426 (1969). Under the current regulations, the rules have been changed so that if the dispute is sufficiently minor that the taxpayer is assured of a profit or a loss on the contract regardless of the outcome of the dispute, such assured amont of profit or loss is accured currently. Reg. § 1.451-3(c)(2). Thus, these rules render it unlikely that a taxpayer will be able to achieve indefinite deferral on long-term contracts where such taxpayer undertakes to delay the final completion and acceptance of a contract by interposing a dispute.

As a further measure to deal with unintended deferral, the regulations contain special rules for determining when a single contract calling for construction of separable units may be severed into separate long-term contracts or when a series of contracts which cover construction of what is basically a single unit of property should be aggregated into a single long-term contract. Reg. § 1.451-3(e). These provisions represent a codification of long-standing judicial decisions. See, e.g., *Grays Harbor Motor Ship Corp.* v. *U.S.*, 45 F. 2d 259 (Ct. Cl. 1930) (a single contract calling for the construction of seven ship holds was considered severable, with each hold being considered a separate project reportable on the completed contract basis); *Helvering* v. *National Contracting Co.*, 69 F. 2d 252 (8th Cir. 1934) (eight individual contracts covering the construction of two schools were held to constitute a single contract, reportable on a completed contract basis).

In conclusion, under both the regulatory rules and judicial precedents in this area, the Internal Revenue Service has ample authority to prevent the unjustified

deferral of income with respect to contracts that are held open indefinitely, whether through operations and maintenance agreements, or any other agreements which are, in substance, separate contracts. Notwithstanding the adequacy of the existing rules to deal with this deferral problem, the Service apparently has experienced enforcement shortcomings. For this, the Internal Revenue Service has itself to blame. In the six years that the current long-term contract regulations have been outstanding, and in the entire 60 year period that the completed contract method has been permitted, not a single revenue ruling has ever been published to detail the situations in which severing or aggregating of contracts would be required. Our committee submits that the Administration should redirect its attention away from repeal of the completed contract method and towards better enforcement of the existing rules.

2. *Period costs.* The second principal type of abuse which the Administration contends is allowed by the existing long-term contract rules is the deductibility of excessive period costs. The Administration claims that such excessive deductions occur under both the completed contract method and the accrual shipments method.

As noted in the preceding section, the costing rules that apply under the completed contract and accrual methods are totally consistent. Moreover, if either set of rules is more advantageous to the taxpayer, it is clearly not the long-term contract rules. Accordingly, if there are excessive deductions in this area, such deductions are allowed not by the completed contract method but by long-standing tax accounting principles which apply to all accrual taxpayers. It is inconceivable that Treasury can ask this Congress to change these long-standing rules without affirmatively changing the rules for all taxpayers, including both taxpayers with long-term contracts and those without. Such rules should not be disturbed lightly and certainly not in the name of correcting abuses.

The committee recognizes that under the current framework of determining which costs must be deferred and which are deductible, there may be particular individual cases of abuse under the current rules. Admittedly, there are several categories of cost in the long-term contract regulations that are nebulously defined. In practice, some taxpayers have undoubtedly taken the benefit of the doubt and claimed a greater proportion of their expenditures as period costs than they may be entitled to under a proper reading of the regulations. To combat such practices, the Administration does not need to require the capitalization of general overhead expenses that all other types of taxpayers are entitled to expense. Instead, the Internal Revenue Service should publish additional guidelines under the existing regulations which clarify the division between allocable contract costs and deductible period costs. Armed with such guidelines, Internal Revenue Service agents would be able to enforce the current regulations. In our committee's view, such a balanced approach would eliminate any existing abuses and obviate the need for more drastic and unfair statutory and regulatory changes.

3. *"Tax-Free" dividends.* The third area of abuse addressed by the Administration's proposals is the distribution of "tax-free" dividends by certain corporations using the completed contract method. Such distributions are presumably not taxable because the distributing corporations utilizing such approach have not recognized any income under their completed contract method of accounting, and, as a result, have no earnings and profits from which to distribute "dividends." Shareholders of such corporations would receive tax-free distributions from the corporation to the extent of the basis they have in such corporation's stock.

If the Internal Revenue Service perceives such tax-free distributions to be an abuse of the completed contract method, and probably rightly so, it can prevent the "tax-free" distribution result by requiring the corporations to determine their earnings and profits on the basis of the percentage of completion method.

B. Evaluation of administration's proposal

Instead of concentrating its efforts on eliminatng the abuses addressed in the Administration's explanation of its tax proposals, the Administration has adopted a far more drastic approach—the repeal of the completed contract method, the accrual method, and the cash method of accounting for long-term contracts. In place of these methods, the Administration would require the use of either the percentage of completion method or a new method, the progress payment method, and would treat certain period costs as tax preference items in the new proposed minimum tax on corporations.

In the case of the percentage of completion method, everyone should be well aware of its shortcomings. From a conceptual viewpoint, the essential weakness of the percentage of completion method is that it taxes gains or losses before they are "realized" in the traditional sense of the term. While there is no specific statutory

rule for determining when an item of income is "realized," the long-standing judicial precedents in this area start with the notion that "realization" requires the receipt or the fixing of a right to receive something of value. See *Eisner* v. *Macomber*, 252 U.S. 189 (1920); *Burnet* v. *Sanford and Brooks Co.*, 282 U.S. 359 (1931); *Continental Tie and Lumber Co.* v. *U.S.*, 286 U.S. 290 (1932).

In contrast, under the percentage of completion method, it is irrelevant whether anything of value is received. Instead, the measurement of income under the percentage of completion method is based exclusively on the percentage of the long-term contract that is deemed completed each year. Thus, even where an estimate of prgress towards completion may be accurately made, the method resorts to a legal and economic fiction in measuring income, i.e., that a taxpayer who has performed one-quarter of the work under a long-term contract has "earned" and, therefore, "realized" one-quarter of the total estimated profit on the contract. The committee is not aware of any other method of accounting under the Internal Revenue Code where taxation is based on such a principle of estimation.

Furthermore, if the percentage of completion method results in the premature taxation of income prior to its realization in cases where progress towards completion is accurately measured, where does this leave the method in cases where progress towards completion is not reasonably ascertainable? As was noted in Rev. Rul. 70–67, supra, the reason that special methods of accounting are permitted to be used for long-term contracts is that the outcome of such contracts is inherently unpredictable. Given that background, it seems inconceivable that the percentage of completion method should be a preferred method of tax accounting as compared to financial accounting.

Even the Administration recognizes the shortcomings of the percentage of completion method. For example, in an analogous context, the Internal Revenue Service recently argued that the taxpayer in *Rockwell International Corp.* v. *Comm.*, 77 T.C. No. 57 (Oct. 13, 1981), could not deduct estimated losses under the lower of cost or market inventory method. The taxpayer was an aerospace contractor that sought to write down its work-in-progress to reflect an "unrealized" loss based upon its estimate of the future unprofitability of the contract. The Court concluded:

"Putting this aside, however, we are satisfied that the uncertainties surrounding petitioner's loss estimate were far too great on September 30, 1969, to permit recognition of any portion of the loss (by way of an inventory writedown or otherwise) for that fiscal year * * *. Given the number of years remaining on the contract, the fact that it was only half completed, the fact that actual costs and revenues significantly exceeded the taxpayer's estimates, and the magnitude of the uncertainties which prevailed on the inventory date regarding both contract costs and revenue, we think that the relatively small spread between the actual and projected outcomes (relative, that is, to total contract costs) can only be viewed as the product of a coincidence, and any comparison between the two is superficial and misleading. We hold, therefore, that petitioner has failed to establish by sufficient objective evidence that its P.O. 181 ending inventory had a value which was less than its cost on September 30, 1969. Accordingly, no inventory writedown is permissible under the terms of section 1.471–4(b), Income Tax Regs."

If estimates of future losses were too speculative to support a market writedown under the inventory provisions in that case, how could the precise same type of estimates be used to measure profit or loss under the percentage of completion method? The percentage of completion method taxes income before it is realized and it measures such income on the basis of estimates that would be considered too unreliable for use under any other provisions in the Internal Revenue Code.

In recognition of the shortcomings of the percentage of completion method, the Administration has proposed an entirely new method of accounting for long-term contracts—the progress payment method. Under this method, progress payments actually received and payments due and payable would be currently taxable. In addition, certain borrowings against a long-term contract would be treated as progress payments. In contrast, costs of performing a long-term contract would only be deductible against, and to the extent of, progress billings.

The progress payment method is a not-so-subtle attempt to tax a taxpayer's gross receipts. The concept of income realization, which is at least estimated under the percentage of completion method, is totally lost under this new method. Where has the history of our income tax laws gone if taxpayers are forced to pay tax on gross receipts rather than income? From the very outset, the Supreme Court has rejected the contention that income is equivalent to gross receipts. Income is only the excess, if any, of the sale price over the cost. In the case of *Doyle* v. *Mitchell Bros. Co.*, 247 U.S. 179, 184, the Court long ago rejected the position that income equalled the gross receipts received by a taxpayer, saying:

"Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence* v. *Howbert* * * * *'Income may be defined as the gain derived from capital, from labor, or from both combined.'*

"Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many of not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we arrive at 'net income.' In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

The progress payment method is not only antithetical to the history of our tax laws, but it is also highly discriminatory in its effect on taxpayers with long-term contracts. While all other accrual basis taxpayers may continue to defer the taxation of progress payments for work to be completed and delivered in a future taxable year (Reg. § 1.451-5), taxpayers with long-term contracts would pay tax currently on such payments under the progress payment method. In contrast, while cash basis taxpayers must include progress payments in gross income when received, all costs of performing the work would continue to be deductible when paid, regardless of whether such costs exceed the amount of income received. Reg. § 1.461-1(a)(1). Thus, the progress payment method would force a taxpayer with long-term contracts to pay considerably more taxes than either an accrual-basis or cash-basis taxpayer who does not have long-term contracts.

Finally, in its proposals for a new minimum tax on corporations, the Administration would add to its list of tax preferences certain period costs incurred on long-term contracts entered into on or before February 26, 1982.

The committee believes that it is totally unfair to consider as a tax preference item period costs under a long-term contract that are identical to costs that may be expensed by any other type of business. As noted in the preceding section, this category of costs is virtually identical to the list of costs which may be expensed by manufacturers, wholesalers and retailers, and service businesses. If these costs are not a tax preference for such other businesses, they should not be a tax preference for taxpayers with long-term contracts.

V. CONCLUSION

The Administration's proposed changes in the tax accounting treatment of taxpayers having long-term contracts is totally unwarranted. For sixty years, the completed contract method of accounting has been widely accepted as clearly reflecting the income of taxpayers doing business under long-term contracts. Furthermore, there is strong indication in many earlier court decisions that such method is perhaps the best practical method for reporting the income of such taxpayers. In addition, wholly apart from any issues which exist with respect to the completed contract method, no changes should be made in the availability of the traditional accrual method of accounting for long-term contracts.

Perhaps even more important than the historical perspective of these rules is the fact that the tax laws should be applied evenhandedly. To change the rules for taxpayers doing business under long-term contracts in the manner proposed by the Administration would subject these taxpayers to rules which are much more stringent than those which would apply to all other business taxpayers using the cash, accrual or some hybrid method of accounting. Such discrimination has never been a part of our tax law without explicit recognition that such discrimination is warranted.

Finally, if there are problems with respect to the taxation of long-term contracts, these problems can be adequately dealt with under the regulations as they now exist. Rather than seek some ill-conceived Congressional solution to their perceived problems, the Treasury should direct the Internal Revenue Service to deal with the problems at the audit level.

Mr. FOWLER [presiding]. Mr. Conable.

Mr. CONABLE. Jack, would you agree that the two abuses most commonly cited for the completed contract method are the two mentioned by Mr. Schneider.

Mr. NOLAN. Yes. Those are the abuses. I do not know the actual extent of such abuses, but I doubt they are extensive. They are problems that have come to light with the completed contract method over the last 10 years, and they are the types of problems that the Aerospace Industries Association addressed itself to in its submission to the Treasury in January of this year. We suggested specific ways that those problems could be cured by Treasury Department. Instead of adopting those suggestions by regulation, as we suggested, they came forward with an extraordinary proposal to repeal the completed contract method altogether for everyone and to substitute a new cash flow concept of taxing income, which is completely unreasonable.

Mr. CONABLE. To a substantial degree the cash management initiative requires the lending of interest free money to the government over the life of the contract. The assumption is there will be a tax liability at the end of the contract. Is that pretty much what they are doing here?

Mr. NOLAN. What they are doing is attempting to tax cash flow on the contract, not income actually earned, and in the aerospace industry there is no connection between income or loss on a contract and the cash flow that occurs.

Mr. CONABLE. You can't really be sure at some stage in the contract whether or not you will have a profit when you complete it.

Mr. NOLAN. Of course the price itself, for example, is geared to all kinds of incentives, cost incentives, performance incentives, value engineering incentives. and the contractor does not know what his price will be until after the contract is over and all those contingencies have resolved themselves.

Similarly, on a typical defense contract there are hundreds, even thousands, of changes during the course of the contract which have substantial cost effects, and the contractor cannot be certain what his total costs under the contract are going to be until near its completion. Until the work has been completed the contractor does not know whether he will have income or loss on a contract. The completed contract method does not simply permit a contractor to wait until completion before he reports profits. It also denies the contractor the opportunity to deduct any losses until the contract is completed and such losses have been actually sustained.

You must wait until the contract is completed until you know what your final price is going to be, and until you know what your costs are going to be. At that point you report either a profit or loss depending on what your results have been.

Mr. CONABLE. Thank you.

Chairman ROSTENKOWSKI. Mr. Nolan, you have indicated in your testimony that you have submitted to Treasury your recommendations for regulatory changes in the completed contract method of accounting. Would you be kind enough to submit that to this committee as well?

Mr. NOLAN. Yes. We would be glad to submit those.

[The information follows:]

Completed Contract Method of Tax Accounting in Aerospace Industry

I. SUMMARY OF THE QUESTION PRESENTED

The completed contract method of tax accounting is used almost universally for federal income tax purposes in the construction, shipbuilding, and aerospace industries. This occurs because in these particular industries, there are extraordinary uncertainties as to profit or loss, which are determinable only as contracts are completed. Further, there is no other reasonable method of tax accounting for determining taxable income in these industries; any other method requires the use of uncertain estimates of receipts and costs.

Use of the completed contract method was extended to manufacturing businesses with contracts of lengthy duration in regulations proposed in 1971. This extension was the result of consultations by several industries, including the aerospace industry, with the Internal Revenue Service, the Treasury Department, and the Staff of the Joint Committee on Taxation. After extensive study, the Internal Revenue Service and the Treasury Department concluded that some manufacturers had already been permitted to use the method. They determined that consistency required conforming changes in the regulations.

The Treasury Department conclusions took into account extensive litigation as to proper tax accounting methods for industries such as aerospace, shipbuilding, nuclear plant construction, and commercial construction. The objective was to resolve the resulting uncertainties on a balanced basis that protected the interests of both the Government and these industries. Thus, the method was deliberately extended to manufacturing industries, including the aerospace industry, by actions beginning in 1971 after careful study by the Treasury Department.

As a result of these actions, reflected in proposed and final regulations issued over the years 1971–1976, virtually all of the aerospace industry has sought and received permission from the Internal Revenue Service to use the completed contract method. Various conditions were imposed by IRS to safeguard its interests, such as limiting the use of carrybacks, and these conditions were accepted by the industry. Moreover, the change to the completed contract method involved significant tradeoffs by the aerospace industry, such as abandonment of the ability to deduct initial high production costs as incurred, and the use of liberal inventory valuation rules.

The method has now been used by most members of the industry for periods from five to ten years. The resulting deferral of tax liability in the industry, and consequent effect upon its cash position, has been taken into account in determining acceptable profit rates and progress payment needs, and thus in the pricing and negotiation of contract terms for the great majority of the industry's products. A withdrawal or substantial curtailment of the existing use of the method would seriously cripple this industry's capacity to provide for the critical defense needs of the United States.

The short-term revenue gain to the Treasury Department from withdrawal or substantial curtailment of the use of the completed contract method by the aerospace industry would be significantly limited by the effect of transition rules. The long-term gain would be uncertain because of the unique tax accounting difficulties in this industry. Prior to adoption of the completed contract method by most aerospace contractors during the 1970s, tax accounting practices in the aerospace industry were quite divergent. During extensive meetings with the Treasury Department in the early 1970s, the Treasury Department was surprised to learn that many aerospace contractors were employing tax accounting methods that were considerably more favorable to the Government than the tax law required. If such contractors are eventually required to abandon or substantially curtail their present use of the completed contract method, many of such contractors will not simply return to their former methods of tax accounting. As a result, the Treasury Department cannot realistically anticipate a significant long-term revenue gain from any such action.

It is unfortunately more likely that there would be a return to the uncertaint which formerly existed and the litigation which prevailed. The same is probably also true in the case of the construction, shipbuilding, and other industries using the completed contract method of accounting where there is a high degree of uncertainty as to the realization of profit or loss until particular contracts are completed.

The Administration has now suggested that it may seek to eliminate, or at least significantly modify, the completed contract method for all industries by legislation, and by regulation. It is imperative that any action in this area be taken only after an intense dialogue between the Treasury Department and the aerospace industry. Experience over the last ten years with the completed contract method has demonstrated its absolute need for tax purposes in the aerospace industry. At the same

time, the application of the existing regulations is a matter appropriate for discussion with the aerospace industry, and some particular subjects for such a dialogue are set forth subsequently in this memorandum. We earnestly request an opportunity for such a discussion at the earliest possible time.

II. THE COMPLETED CONTRACT METHOD

A. Historical background.—The completed contract method of tax accounting has been sanctioned by Treasury Regulations since 1918.[1] In subsequent years, substantial controversy developed over the use of estimates in determining income and in the treatment of advance or progress payments for goods to be delivered in the future, issues which particularly affected the construction, shipbuilding, and aerospace industries.[2] The possibility of large losses on long-term contracts by manufacturers using the accrual method of tax accounting led these manufacturers to seek loss deductions under the lower-of-cost-or-market inventory convention available to accrual basis taxpayers, and the courts allowed these losses.[3]

Many controversies also developed between the IRS and the aerospace industry as to the use of the accrual method. For financial accounting purposes, the industry to a substantial degree averaged its cost of sales upon deliveries over the entire number of units under a defense contract, or commercial airplanes under a "program" to build a given mode. This reflected the fact that the construction of the initial airplanes, missiles, or space vehicles results in a much higher unit cost than subsequent units. Direct labor costs in this highly labor-intensive industry reflect the intricate fabrication and assembly of hundreds of thousands of individual parts or pieces for any unit. These direct labor costs follow a "learning curve" as production proceeds from one unit to the next under the contract or program. Material costs reflecting spoilage, and tooling costs to some extent, follow the same pattern. The product is priced under the defense contract or commercial airplane program on a unit basis which reflects an averaging of these major costs, and financial accounting often follows the same concepts to determine profits or losses as units are delivered.

For tax purposes, however, the initial high level of costs of units delivered could be deducted on the accrual basis as deliveries of these initial units occurred. The costs had been actually incurred. At the same time, these abnormally high costs, which would result in large losses if deducted, would normally be recovered in the price of units to be subsequently delivered under existing contracts. Some companies deducted the high costs attributable to the initial units as they were delivered. Other companies followed their financial accounting treatment and averaged their costs over their defense contracts or commercial airplane program on a contract-by-contract or program-by-program basis. This averaging, however, necessarily involved the estimation of future costs of production under the contract or program in determining the costs to be deducted on the delivery of the early units.

The Internal Revenue Service was unhappy with either alternative—one involved the deduction of losses that could be said to be unrealistic, and the other involved the extensive use of "estimates"—which is anathema to the IRS. As a result, much controversy existed in the 1950–1971 period.

In 1970, the President's Task Force on Business Taxation addressed itself among other issues to areas of controversy such as this one and strongly recommended new initiatives in regulations to reduce the resulting uncertainties in business taxation.[4] The completed contract regulations were one of these initiatives. They followed perhaps the most intensive debate and analysis between the Treasury Department and the Internal Revenue Service of any of the reguation projects at that time. Among other objectives, they were deliberately designed to offer a reasonable alternative to the aerospace industry to resolve its unique tax accounting problems, while still protecting the interests of the Government by requiring capitalization and deferral of

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[1] Reg. 121, § 33. The courts upheld the application of these regulations in early cases such as *Badgley* v. *Commissioner*, 59 F. 2d 203 (2d Cir. 1932), and *James C. Ellis*, 16 BTA 1225 (1929).

[2] See Schneider, *Tax Accounting for Contractors: Planning Under the New Regulations*, 35 N.Y.U. Ann. Inst. 29, 31-36 (1977).

[3] *Space Controls, Inc.* v. *C.I.R.*, 322 F. 2d 144 (5th Cir. 1963) rev'g and rem'g 21 TCM 295 (1962); *E. W. Bliss Company* v. *United States*, 351 F. 2d 449 (6th Cir. 1965). See also *St. James Sugar Coop, Inc.* v. *U.S.*, 643 F. 2d 1219 (5th Cir. 1981). In *Rockwell International Corp.* v. *Commissioner*, 77 T.C.—, No. 57 (Oct.13, 1981) the Tax Court denied such an inventory write-down for the taxpayer's fiscal year ending September 30, 1969. The taxpayer is expected to appeal to the Third Circuit.

[4] *Report of President's Task Force on Business Taxation*, Sept., 1970, p. 60.

the deduction of costs until completion of the contract, thus denying the deduction "up-front" of substantial but perhaps unrealistic losses.

B. Development of the regulations.—The first proposed regulations contained a financial conformity requirement. This necessarily would have insured that costs could not be deducted for tax purposes before they were treated as cost-of-sales or expenses for financial accounting purposes.[5] The conformity requirement would have dramatically restricted the availability of the completed contract method to all of the affected industries. It was severely protested by the construction industry and its Congressional representatives. It was thereupon abandoned.

The revised proposed regulations issued December 15, 1971,[6] eliminated the financial conformity requirement but required complete consistency in the treatment of indirect costs with the full-absorption inventory regulations. Under the latter regulations, some indirect costs must be capitalized as inventory costs in all events, some must be deducted as period costs in all events, and some must be treated either as inventory costs or as period costs depending upon their treatment for financial accounting purposes.

In the final long-term contract regulations issued on January 14, 1976, this latter treatment of costs was eliminated. Instead, the Treasury Department undertook to specify the treatment of all costs either as costs of the contract, to be deferred until contract completion, or as period costs, in accordance with then-existing precedents in court cases and published rulings.

The final completed contract regulations provide that the current service portion of pension costs and certain other employee benefit costs need not be treated as costs of the contract, but rather are to be treated as period costs.[7] This directly parallels the treatment of such costs with respect to self-constructed property. In I.T. 3408,[8] a ruling still in effect, the IRS determined that pension costs for construction workers are a period cost. When it proceeded to litigate the capitalization or depreciation with respect to self-constructed property in the Supreme Court in the *Idaho Power Co.* case, it specifically conceded the deductibility of pension costs, reflecting a widespread belief in the IRS that there is no authority to require any capitalization of qualified plan pension costs inasmuch as their deduction is provided for specifically in Code § 404.[9]

The treatment of pension costs as a period cost in the long-term contract regulations is also consistent with their treatment in the full-absorption inventory regulations with respect to accrual basis taxpayers that employ a non-conforming method of accounting for financial reporting purposes.[10]

The relationship of the treatment of costs for inventory purposes under the accrual method and in the completed contract method is self-evident. Under the accrual method, income is accrued as deliveries of units occur and thus as the contractor is deemed to earn a specified portion of the contract price for the units delivered. Costs of manufacturing the units, including allocable indirect manufacturing costs, must be capitalized as inventory costs and deducted as cost-of-sales as the units are delivered. Under the completed contract method, income is not accrued until the entire contract or program is completed, and costs of manufacturing the units (including certain allocable indirect manufacturing costs) must be capitalized and deferred until such completion. Losses may not be recorded under the completed contract method until the contract is completed; there are no exceptions to this rule. Under the accrual method, losses may be recorded by virtue of the cost-or-market inventory convention, to the extent of costs incurred, prior to the time that it is known whether or not losses will actually be sustained.

From the standpoint of tax policy, it is equally important to insure both that—(1) losses are not recorded before they are actually sustained (except pursuant to the cost-or-market inventory convention); and (2) income is recorded at the time that it is actually earned. The accrual method as applied in the *Space Controls* and *E.W. Bliss* cases permits losses to be reflected based on estimates of future performance; the completed contract method, while not permitting the recording of losses, must

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[5] Prop. Reg. § 1.451-3 (March 24, 1971).

[6] Prop. Reg. § 1.451-3 (Dec. 15, 1971).

[7] Reg. § 1.451-3(d)(5)(iii)(*b*). Compare Reg. § 1.471-11(c)(2)(iii)(c) and (ii)(*b*).

[8] 1940-2 C.B. 178.

[9] *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974). In 1978, the Internal Revenue Service commenced a regulations project, EE 56-78, to require capitalization of § 404 costs with respect to self-constructed assets. The project has never been completed, possibly because of uncertainty as to the validity of the rule it would propose. See *All-Steel Equipment Inc.*, 54 T.C. 1749, 1766 (1970); I.T. 3408, supra, footnote [8].

[10] Reg. § 1.471-11(c)(3)(ii)(*b*).

be applied so as to insure that the contractor reports profits when there is sufficient certainty that they have been earned, but not before that time.

III. THE COMPLETED CONTRACT METHOD IS ESSENTIAL FOR PROPER TAX ACCOUNTING FOR THE AEROSPACE INDUSTRY

A. The risks and uncertainties of the industry.—The conceptual basis of the completed contract method was accurately stated by the IRS in 1970:

"One of the reasons why permission to report on a completed contract basis is given in the case of building, installation and construction contracts, is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay and unexpected difficulties in laying foundations which make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed." [11]

These uncertainties, both as to price and to cost, exist to a much greater degree in the aerospace industry. Major technological break-throughs continue to occur during the development and production of any major weapons system, requiring extensive engineering changes to units already produced and yet to be produced, with resulting major uncertainties as to costs and prices for the product. These are technological changes not known at the time the contract was entered into. In fact, it is unique to the aerospace industry that it enters into combined development-production contracts of long duration calling for the contractor to invent and develop new products.

The result of these conditions is that in the performance of any major defense or commercial contract by the aerospace industry, there are very frequent technological advances, often overlapping and replacing one another, with major effects on cost. The uncertainties of costs and prices in the aerospace industry have very little, if any, counterpart elsewhere in American industry. Thus, there is no other industry in which catastrophic losses on particular contracts or programs occur in the magnitude and with the frequency and unpredictability that they occur in the aerospace industry.

On the pricing side, the Defense Department and other agencies buying from aerospace companies utilize the most sophisticated price techniques imaginable. They include infinite varieties of contracts which are fixed price, fixed price with redetermination clauses, fixed price incentive contracts, cost plus incentive fee contracts, cost plus fixed fee contracts, cost plus award fee contracts, and others. The incentive provisions may be based on the variation in actual costs from target costs, with maximum price provisions so that the contractor at some point bears the risk of 100 percent of cost overruns; or upon performance incentives based upon specific achievements, such as speed, altitude, rate-of-climb, accuracy of missiles, or more complex objectives; or upon value engineering concepts; or upon combinations of all of the foregoing factors. Major defense contracts in the aerospace industry, both cost and fixed price type contracts, normally contain provisions for cost and performance incentives which make profit highly uncertain until the completion of the contract, when the effect of the incentive provisions is first fully known. Operation of the incentive formulas could result in a final profit substantially greater or less than originally anticipated and negotiated, or could even result in a net loss. In addition, such contracts normally contain a ceiling price, exposing the contractor further to substantial risk of loss.

In addition to technological changes and incentive formulas, other regulatory and contractual provisions and procurement practices virtually assure that the profit or loss position of an aerospace contractor on a major defense contract cannot be ascertained with any reasonable degree of certainty until completion of the contract. The Government retains the right throughout contract performance to terminate the contract in whole or part for any reason. Such a termination can reduce very significantly the contractor's expected profit. Moreover, the Government frequently directs major changes to be made, but the contractor is required to proceed with the work as directed and to later negotiate the price for those changes. The difficulties in segregating the cost caused by such changes, quantifying the amount of increased or decreased cost resulting from the changes, and disagreements over allocation, allowability and reasonableness of cost incurred, can result in protracted negotiations and litigation with no assurance that the contractor will recover the full cost of such changes.

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[11] Rev. Rul. 70-67, 1970-1 C.B. 117.

The Government is normally responsible for costs caused by defects in, or late delivery of, Government furnished equipment, drawings, and specifications. A contractor, however, can experience substantial delay, disruption, test, rework, and other costs before the problem might be identified as caused by the Government furnished equipment, drawings, and specifications and before the accounting procedures can be established to segregate such costs. A contractor's profit or loss position on a contract may vary significantly depending on the contractor's ability, on a retroactive basis, to identify and quantify such cost increases.

While the analysis in this memorandum tends to emphasize the uncertainties of prices and costs in defense contracting, these uncertainties exist to the same degree with respect to commercial business, including sales to domestic airlines and to foreign governments, foreign airlines, and others. These commercial sales are very substantial, and export sales are a large portion of total U.S. exports. The uncertainties are increased by intense competition both within and without the United States by foreign aerospace companies, often supported in varying degrees by their respective governments. The European airbus, for example, represents severe competition for U.S. aerospace products in sales to U.S. airlines.

The enormous risks of defense contracting are further reflected in particular programs that have been well-publicized. Grumman lost $260 million on the F-14 fighter program; Lockheed lost $484 million on a group of Government contracts, including the C-5A, Cheyenne helicopter, and SRAM missile motor, which were settled as a package in 1970; General Dynamics lost $359 million in building the SSN688-Class submarine. This list would be much longer if smaller companies were added. Arguments over efficiency, management, cost controls, technological problems, or otherwise are irrelevant in the present analysis; these numbers represent actual losses incurred that are deductible for federal tax purposes.

The cases are not limited to defense contracts. Lockheed announced in December, 1981, the discontinuance of the L-1011 program, with 1981, losses in excess of $800 million, following the previous recording of nearly $1.7 billion in losses on that program in the years 1968-80. There have been other major commercial airplane programs in the last twenty years that have also resulted in major unexpected losses.

In the case of virtually all of these programs, the products were originally priced by both parties to yield a profit. The incredible technological developments in the aerospace industry in the last three decades have made it impossible to forecast costs, and thus prices, with the degree of accuracy required for effective tax administration. Contractors are frequently required to commit to prices before the product to be developed and manufactured has even been invented. The development and production of the end products is in a state of constant flux, both engineering-wise and cost-wise. The engineering changes on programs such as those above can range from 500 to over 6,000 or more during the course of a typical contract. There is no way to determine with reasonable certainty whether the manufacture and delivery of the products based on the initial cost estimates, and thus the contract price, will result in profits or losses.

The profit and loss uncertainties of the aerospace industry are further compounded by the Government procurement concept of "unallowable" costs. All Government contractors are required by Public Law 87-653 to make full disclosure of all anticipated costs in negotiating significant contracts and contract amendments. Pricing cannot, for the most part, reflect costs such as interest, advertising, or contributions, although these costs are very substantial in this industry, even with respect to Government business. In addition, other major costs are only allowable within strict limits, including, but not limited to, research and development costs, bid and proposal costs, and certain professional services. Studies have shown that these unallowable costs exceed 1.5 percent of sales, reducing before-tax earnings by 25 to 30 percent.

A 1974 report by the General Accounting Office[12] reviews the "cost growth" in major weapons systems up until that time. The unanticipated cost-growth of 55 major weapons systems received was over $7 billion in six months' time. The report concludes as follows:

"Cost growth in major weapon systems results from such things as unanticipated development difficulties, faulty planning, poor management, bad estimating, or underestimating. However, not all cost growth can reasonably be prevented. For instance, unusual periods of inflation may result in cost growth. Changes in technology may make it possible to incorporate modifications that result in an overall increase in the system's effectiveness. Such cost growth cannot always be anticipated,

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[12] "Report to the Congress, Status of Selected Major Weapons Systems," Comptroller General of the United States (May 13, 1974).

particularly when a weapon system is in development and production over long periods."

The statement that "not all cost growth can reasonably be prevented" is a significant understatment of the experience of the aerospace industry.

The unique risks of defense contracting are vividly illustrated by the magnitude of the cost and effort merely to compete for contracts. Agency requests to industry to submit proposals for programs such as SRAM missile, Cheyenne helicopter, C–5A, and B–1 aircraft average 1,000 to 2,000 pages, and contractors' responses normally range between 15,000 and 30,000 pages.[13] One contractor expended $25 million in costs to compete for the F–15 contract, which is lost. In the case of the B–1 program, the Air Force spent $140 million on feasibility and other studies during 1965–70 to write the development specifications. Seven companies spent $66 million while preparing and waiting for receipt of the request for proposals and five companies spent $36 million in company funds responding to the request. In short, it cost nearly one quarter billion dollars to prepare for the B–1 competition, to prepare the proposals, and to await the source selection decisions.[14]

The Department of Defense reported to Congress that major defense contractors incurred $3.3 billion in bid and proposal and independent research and development costs in fiscal year 1980. As a result of regulatory provisions limiting allocation of such costs to Government contracts, the Defense Department accepted only $2.6 billion of such costs for allocation to all of the contractors' work, commercial and Government. The share paid by the Department of Defense was $1.4 billion.

B. Cost-type contracts.—Popular misconceptions exist that contractors in the defense industry are assured of recovery of their costs under cost-type contracts and that accrual of profit with reasonable certainty is possible. Nothing could be further from the actual facts.

Some cost-type contracts whether cost plus fixed fee, cost plus award fee, or cost plus incentive fee, include maximum cost recovery provisions, exposing the contractor to substantial risk of loss of profits, or even some risk of loss. Some cost-type contracts give the Government an option to purchase additional quantities at fixed prices, or on a fixed price incentive contract basis, which subjects the contractor to major risk of loss of profit, or actual loss, when the cost-type contract and the fixed price option are considered together. Further, in any cost type contract, the contractor is always at risk of loss of all part of the fee because of "unallowable" costs, as previously described. The fixed fee on a CPFF contract will often be only in the 3 percent to 7 percent range, and unallowable costs can substantially reduce or possible exhaust this narrow profit margin.

In the case of cost plus award fee contracts, the contractor's fee is entirely at the judgment of the Contracting Officer. This judgment ordinarily is not rendered until near the completion of the contract, when the most critical performance tests occur. The fee may range from 0 percent to 15 percent at the Contracting Officer's discretion. An interim award, say at 7.5 percent, can be eliminated by a final award of 0 percent. There is no way the fee can be accrued until the completion of the contract under traditional tax accounting principles—when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.[15]

In the case of cost plus incentive fee contracts, the same uncertainty exists until contract completion. Under a particular contract for a major acquisition of missiles, the "target" fee was to be 8 percent of estimated total "target" cost. The cost incentive provisions stated that cost overruns could reduce the fee to 5 percent and cost underruns could increase the fee to a maximum of 11 percent of cost. Performance incentives could further reduce or increase the fee by as much as 3 percent of costs. Thus, the fee could be as little as 2 percent or as much as 14 percent.

The performance incentives under the foregoing contract were heavily weighted toward flight tests and accuracy tests, which would occur in the last six months of a contract expected to require five years to perform. If the contractor were to accrue a fee of, say 8 percent of costs incurred in the early stages of performance, a disastrous flight test and cost overruns could easily result in the necessity of booking a large negative fee in a very small amount of "sales" in the last year of performance. This in not the kind of certainty required for accrual of income for tax purposes.

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[13] One program proposal to the Air Force for the AWACS contained 26,000 pages and involved 16,000 people in its preparation. Printed proposal material submitted by the three airframe and two engine contractors on the C–5A competition totalled 240,000 pages.

[14] Report of the Commission on Government Procurement, December 1972, vol. 2, p. 137.

[15] Reg. §1.451–1(a).

Cost reimbursement contracts are used in those cases in which there is the most cost uncertainty. They are used where the work is essentially developmental in nature and thus where there is an inability to estimate costs to provide a basis for a fixed price type of contract. There is no comparable cost experience on any other contract, and no other reliable basis on which to determine costs.

In a very real sense, the completed contract method is most appropriate for cost-type contracts.

C. Other methods are not proper.—If the use of the completed contract method were denied to the aerospace industry, it would be necessary to prescribe the use of another method. If no other requirement were imposed and the accrual method were available, contractors would be free to treat as cost-of-sales of initial units delivered the actual costs of those units, even though this might result in substantial losses. At the very least, they might be entitled to utilize the cost-or-market inventory convention to reflect losses at the earliest time those losses could be reasonably estimated.[16] Presumably, these consequences would not be acceptable to the Treasury Department, though it is impossible in principle to justify treating the aerospace industry differently from any other industry, including the construction industry.

The percentage-of-completion method is not suitable. Such method requires a determination of the degree of cost completion or physical completion of contracts.[17] There is a substantial amount of subjective judgment applied in the use of the percentage-of-completion method. It is not possible in the aerospace industry to make these determinations with sufficient accuracy for tax purposes, which requires annual tax accounting based on a reasonably high degree of certainty and objectivity.

It was this very impossibility, and the uncertainty of using estimates of future performance, that led to extensive reconsideration and the changes in the completed contract regulations in 1971.[18] The IRS should not be satisfied with a tax accounting method which determines profits and losses in any given year by contractor estimates of future costs or future performance. Because of the inherent difficulties in the aerospace industry in determining costs and prices under contracts until they are completed, profits and losses may be distorted as between years. The result might be even greater uncertainty and controversy than existed prior to 1971. Lessons should be learned from the past. There is virtue in stability and certainty, particularly as to tax liabilities; indeed, it is a necessity.[19]

Otherwise, no alternative tax accounting method suggests itself. The difficulties are compounded by the sophisticated pricing techniques for aerospace products; it is extremely difficult at any point in time in the performance of an integrated contract to determine how much "profit" the contractor has earned, or how much "loss" has been sustained. The uncertainties in costs created by double-digit inflation and by the continuing galloping pace of technological change compound the difficulties.

IV. THE ADVERSE IMPACT OF DENIAL OF THE METHOD UPON DEFENSE POLICY

Serious questions presently exist as to the capability of the United States defense industrial base to fulfill effectively its critical role in national security. In testimony before the Defense Industrial Base Panel, General Alton Slay, Commander of the Air Force Systems Command, observed that the United States had been able to generate a massive surge to mobilize its manpower and industrial base in the past, but that, today, the United States defense industrial base lacks standby capacity, weapons systems are more complex, "and we would be caught flat-footed for even the basic materials from which defense articles are made."[20]

The Administration is sponsoring increases in the procurement of defense products of the most sophisticated nature, placing further strains upon the capacities of our defense industrial base. The completed contract method contributes to severely-needed funds in the aerospace industry for both working capital and new capital investment. This is essential to a rejuvenated defense program. The Accelerated Cost Recovery System can provide only limited benefits, because many companies in the industry are more labor-intensive than fixed asset-intensive, as contrasted with other major United States industries.

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[16] See *Space Controls, Inc.* v. *C.I.R.*, supra, and *E. W. Bliss Company* v. *United States*, supra, footnote 3. But see *Rockwell International Corp.* v. *Commissioner*, supra, footnote 3.

[17] *See* Reg. § 1.451-3(c)(2).

[18] *See*, supra pp. 4–10.

[19] *Report of the President's Task Force on Business Taxation*, September, 1970.

[20] *Federal Contracts Report*, Bureau of National Affairs, Vol. 857, Nov. 17, 1980, p. A–25.

It is sometimes overlooked that defense contractors typically have large net investments in work in process under Government contracts as well as under commercial contracts. While the cost of operating capital necessary to finance work in process has increased dramatically, the cost of money for operating capital is not an allowable cost under defense contracts. The usual progress payment has been 80 percent of costs for contractors other than small business (increased to 90 percent in late 1981). Because of time lags in recording costs, submitting billings, and receiving payment, a recent industry survey indicated that progress payments provide only about 60 percent of the working capital investment and the contractor must provide the balance of 40 percent (which should drop to about 30 percent with 90 percent progress payments).[21]

As previously demonstrated, a major purpose of the revision of the long-term contract regulations in the period 1971–1976 was to attract the aerospace industry into that tax accounting system to provide reasonable certainty of tax consequences and forstall acceleration of estimated losses. The Treasury's program was successful, with virtually all major aerospace contractors now having adopted the method. A recent, informal survey of twenty-two major aerospace defense contractors was conducted. About one-half of these companies reported that the deferred tax liability attributable to the completed contract method is now equivalent in amount to 25 percent of the shareholder equity of these companies.

As noted previously, withdrawal or substantial curtailment of the right to use the completed contract method will cause tremendus uncertainty in the aerospace industry. Years of litigation may ensue, which will affect significantly the financial positions of companies and force them to make important operating decisions without any degree of certainty as to the outcome.

Under these conditions, any such withdrawal or substantial curtailment could have very serious adverse effects on United States defense capabilities and on this industry. It would require the industry to go to the financial markets for massive amounts of new capital. The industry is already poorly-rated by the financial markets, and new capital would be obtained, if at all, only at unduly-high interest rates. Weaker companies, though owning facilities which are vital to our national defense industrial base capacity, could be forced into unwise mergers. In extreme cases, for national security reasons, Government intervention might be necessary.

Although interest for the most part is not an allowable cost for defense pricing purposes, it obviously must be recovered by aerospace companies in the pricing of their products. Accordingly, profit percentages on defense contracts necessarily reflect the interest and other debt service costs of the contractor. The Government has recovered much of the benefit of the completed contract method through lower prices, resulting from reduced profit rates made possible by the deferral in time of payment of contractors' tax liabilities. If the industry must incur market interest costs on borrowings to replace this capital, the Government will bear much of the cost in higher profit rates on new defense contracts; othewise, the defense industial base will be eroded. To the extent the cost of borrowing in the marketplace exceeds the implicit interest rate borne by the United States on its debt, or earned on its funds, the Government will incur added defense costs unnecessarily.

More importantly, in any transition process, the United States will lose much of the dynamic progress presently underway in the aerospace industry in improving its productive capacity, its efficiency, its investment in new independent research and development, and its capital planning. This progress has been ignited by the President's determined program to increase defense expenditures so as to improve our strategic position, our defense capacity, our defense industrial base, and our research in new weapons systems and aerospace science. The Department of Defense has been promoting these developments by new initiatives such as flexible progress payments, economic price adjustment clauses, and multi-year procurement commitments.

In summary, if a major change in use of the completed contract method is to have any substantial revenue effect, the defense posture of the United States would be jeopardized in many ways. The Government would lose more than it would gain.

V. REVENUE IMPACT

The revenue consequences of withdrawal or substantial curtailment of use of the completed contract method by the aerospace industry would be quite uncertain. If the action is limited to the aerospace industry, there will be a court test whether discrimination on an industry basis in tax accounting treatment is constitutional. Further, the revenue impact of use of the accrual method or the percentage-of-completion method by the aerospace industry is far from clear.[22]

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[21] *Federal Contracts Report*, Bureau of National Affairs, No. 864, January 12, 1981, p. D–7.
[22] See supra, pp. 5–7 and pp. 21–22.

Perhaps more importantly, a reasonable transition rule would be required. The industry will seek a forgiveness of its deferred tax liability with respect to prior years, inasmuch as the change is one initiated by the Government, citing the enactment of section 481 in the 1954 Code as precedent.[23] At the very least, the industry will likely be given an extended period over which to take into account this deferred tax liability. There are well-established precedents for a period of ten, or even twenty years for this purpose.[24] The suspense account technique used elsewhere in the code for this purpose would result in no recovery of the deferred tax liability in a period of stable or increasing business.[25]

Thus, there might be little, if any, revenue gain with respect to the deferred tax liability attributable to the completed contract method for the period up until any change of method is required by legislation or regulation. If the "cut-off" method were used, as the IRS has prescribed in the past for changes in method of accounting for long-term contracts, the full impact might be even further delayed. Under that method, the completed contract method would be denied only with respect to any contracts entered into after the date of the required change in method.[26]

In the case of new contracts resulting from increased defense expenditures, or otherwise, the impact will be delayed substantially. Contracts in the aerospace industry, whether defense or commercial, typically involve long leadtimes from the time of execution until the time when substantial production activity is undertaken and deliveries are made. Even under a percentage-of-completion method, the bulk of the profit is likely to fall in the later years of the contract.

It is highly unlikely that withdrawal or substantial curtailment of use of the completed contract method by the aerospace industry will begin to have any substantial revenue consequences until 1985 or 1986. This does not mitigate the adverse impacts of any such action upon defense policy,[27] however, since the capital planning of the industry would be disrupted by the action itself, even though its revenue impacts were delayed several years in time.

VI. CHANGES IN EXISTING REGULATIONS

As previously stated, a discussion of the application of the existing regulations relating to the completed contract method with the aerospace industry is appropriate. Some suggested areas of discussion include the following:

A. Severing and aggregation of contracts.—The existing regulations contain provisions for treating one agreement as several contracts and several agreements as one contract in appropriate cases.[28] One agreement may be treated as several contracts where there is separate delivery or separate acceptance of portions of the subject matter of the contract, or there is no business purpose for entering into one agreement rather than several agreements, and, in effect, the costs and prices of each of the separate portions are independent of one another. The key test is whether the contractor would have entered into a contract to construct or manufacture one portion of the contract in question without entering into a contract to construct or manufacture another portion. If the one portion is likely to result in little or no gain, while the other portion is likely to result in substantial profits, there is to be no severance.[28] This latter case, of course, describes the typical aerospace contract for delivery of various units where the pricing is based on average costs and the costs of the initial production are much higher than the costs of later production.[29]

Consideration could be given to amplifying this rule with examples to insure that add-on quantities under the contract do not extend the life of the contract, but are to be treated as a separate contract or contracts, where the add-on quantities are priced independently of the pricing under the original contract. Similar consideration could be given to such a provision for spare parts, technical manuals, supplementary services such as training of customer personnel, or other elements of the original contract, the pricing of which is independent of the pricing of the basic units to be produced under the contract.

Consideration could be given to the same rule (that the contract is not extended) for additional units produced under the original contract pursuant to an option ex-

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[23] See Code § 481(a)(2).

[24] See Rev. Proc. 70-27, 1970-2 C.B. 509; Rev. Proc. 71-16, 1971-1 C.B. 682, sec. 3.02; Reg. § 1.471-11(e)(3)(i).

[25] See, for example, Code § 166(f)(4).

[26] See Schneider, *Coping With the IRS' Unpublished Rules for Handling Accounting Method Changes*, The Journal of Taxation, April 1978.

[27] See supra, pp. 23-26.

[28] Reg. § 1.451-3(e)(2), Example (2).

[29] See supra, pp. 5-7.

ercisable by the customer (whether the U.S. Government, a foreign government, or commercial) where the price of the basic units under the original contract is not increased if the option is not exercised. This latter rule should not apply, however, if it appears that the contract for the basic units will result in little gain unless the option is exercised and their is a reasonable expectation at the time the original contract is entered into that the option will be exercised.

B. Completion of the contract.—The existing regulations state that a long-term contract will not be considered "completed" until final completion and acceptance have occurred, although a taxpayer "may not delay the completion of a contract for the principal purpose of deferring Federal income tax".[30] This rule was finally prescribed, in lieu of the "substantial completion" standard in the proposed regulations, to avoid the litigation that would necessarily result, and had previously existed, as to when the contract was deemed to be completed.

Attention might be given to whether this rule should be re-developed to prevent relatively minor disputes as to acceptance of discrete portions of the contract which are not the principal articles being produced from delaying completion. This rule should not, however, extend to the principal articles being produced, because the contractor may incur substantial costs in modifying one or more of the principal articles being produced to meet the customer's demands even where the dispute can be characterized as relatively minor. This can vitally affect the contractor's profit or loss under the contract. In any event, the rule should not be changed to re-introduce the concept of "substantial completion", unless it is greatly amplified in comparision to the 1971 proposed regulations.

This is an area particularly as to which further dialogue between the Government and the aerospace industry would be productive in developing reasonable rules.

C. Treatment of costs.—There are a number of particular cost categories under the existing regulations which could be given further consideration. The rules should, however, continue to be consistent to the maximum extent possible with the full-absorption inventory costing regulations. There is no justification in principle for treating costs more severely for a completed contract basis taxpayer than for an accrual basis taxpayer.[31]

1. Pension costs.—Consideration might be given to whether current service pension costs should be treated as costs properly allocable to a long-term contract if the taxpayer uses inventories for financial accouting purposes and treats such costs as inventoriable costs for those purposes. If the contractor uses the percentage-of-completion method, or some other method not involving the use of inventories, for financial accounting purposes, current service pension costs should not be treated as properly allocable to long-term contracts.[32] Past service pension costs should continue to be treated as period costs in all events, as they are under the full-absorption inventory regulations.[33]

2. Employee benefits not specified in regulations.—Attention might be given to whether employee benefit costs in addition to those specified in the existing regulations [34] should be required to be treated in the same manner as suggested above for "pension costs." [35]

3. General and administrative expenses.—The treatment of general and administrative costs, officers' salaries, insurance costs, and similar costs under the existing regulations, either as costs properly allocable to long-term contracts or as period costs, depends upon whether—(1) they are "incurred in the performance of particular long-term contracts"; [36] or (2) they "benefit the long-term contractor's activities as a whole".[37] The question may arise in any reconsideration of the long-term contract regulations whether these provisions should be changed.

At the outset, it is critical to observe that the full-absorption inventory regulations provide, in effect, that these costs are not to be deferred and carried forward, but instead are to be expensed as incurred, to the extent they are "incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes." [38] This is the case irrespective of the financial

[30] Reg. § 1.451-3(b)(2); compare Prop. Reg. § 1.451-3(b)(2) (Dec. 15, 1971); see Schneider, *Tax Accounting for Contractors: Planning Under the New Regulations*, supra; *V.T.H. Bien*, 20 T.C. 49 (1953); *Thompson-King-Tate* v. *U.S.*, 296 F. 2d 290 (6th Cir. 1961); *E. E. Black, Ltd.* v. *Alsup*, 211 F. 2d 879 (9th Cir. 1954); *Rice, Barton & Falls, Inc.* v. *Commissioner*, 41 F. 2d 339 (1st Cir. 1930); *King* v. *United States*, 220 F. Supp. 350 (E.D. Texas 1963).

[31] See supra, pp. 7-10.

[32] See Reg. § 1.471-11(c)(3), (3)(ii)(*b*).

[33] Reg. § 1.471-11(c)(2)(ii)(*b*).

[34] Reg. § 1.451-3(d)(5)(ii)(*e*).

[35] Reg. § 1.471-11(c)(3)(i)(*e*).

[36] Reg. § 1.451-3(d)(5)(ii)(*l*), (*m*), (*n*).

[37] Reg. § 1.451-3(d)(5)(iii)(*e*), (*m*).

[38] Reg. § 1.471-11(c)(2)(ii)(*l*), (*m*).

accounting treatment; these costs are the so-called "Category 2" costs rather than "Category 3" costs. Where the contractor uses different accounting methods for book and tax purposes, these costs are treated as period costs in all events.[39]

Under these conditions, while some minor variation in the language of the regulations may be appropriate, the basic treatment of general and administrative expenses under the existing regulations should not be changed. In fact, these costs are costs of the period, not of the product, and they do not represent value added that fairly should be capitalized. Companies using the completed contract method should be treated no differently in principle than taxpayers with inventories using the accrual method.[40]

VII. CONCLUSION

The use of the completed contract method is vital to proper tax accounting in, and to the financial stability of, the aerospace industry. There is no reasonable alternative that might not allow either undue acceleration of losses that may not be actually incurred, on the one hand, or the reporting of taxable income that may never materialize, on the other hand. The risks and uncertainties of the aerospace industry are extraordinary and unique, and unanticipated "cost-growth" in major weapons systems is the rule rather than the exception. The pricing and costing of products of the aerospace industry necessarily reflect major technological uncertainties and are only fairly reflected for tax purposes by the completed contract method.

The Treasury Department carefully developed the completed contract method in regulations in the 1971–1976 period for, among other purposes, the objective of resolving the tax accounting treatment of the aerospace industry. This thorough consideration and evaluation should not be abandoned.

The aerospace industry responded by embracing the completed contract method almost universally. The result is that a large part of the operating capital of the industry is now reflected in deferred tax liabilities attributable to the completed contract method. A withdrawal or substantial curtailment of the method could have severe adverse impacts on the aerospace industry and thus on the United States defense industrial base. The ACRS system is by no means a substitute. The important initiatives in capital planning, increased efficiency, independent research and development, and increased capacity which have been stimulated in the aerospace industry by the present Administration should not be disrupted by such a tax change.

The revenue effect of any such change will be highly uncertain in the near term (1983–1985). This results from the necessity of appropriate transition rules and the delayed effect of any such change. Major tax accounting controversies will result from the abandonment or substantial modification of the completed contract method. The consequences may be as destructive for the Treasury Department as for the aerospace industry. To make such changes and label them as a "loophole closer", in view of the Treasury's original intent in this area to raise revenue, would be to distort the history of the development of the completed contract method. The aerospace industry must strongly oppose any Treasury proposal to restrict substantially the availability of the completed contract method.

The aerospace industry stands ready to discuss with the Treasury Department its special need for the completed contract method and the particular justification for the use of that method for sound tax administration in its industry. At the same time, as suggested in this memorandum, the industry is prepared to discuss particular areas of possible change in the existing regulations. The aerospace industry earnestly seeks an opportunity for constructive dialogue in these matters.

Chairman ROSTENKOWSKI. Mr. Fowler is recognized.

Mr. FOWLER. I have no questions.

Chairman ROSTENKOWSKI. Mr. Gephardt is recognized.

Mr. GEPHARDT. Thank you. No questions.

Chairman ROSTENKOWSKI. Mr. Vander Jagt is recognized.

Mr. VANDER JAGT. No questions.

Chairman ROSTENKOWSKI. Gentlemen, thank you for joining us. We welcome to the committee Mr. Holleman.

If you will identify yourself for the record, you may proceed with your testimony.

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[39] Reg. § 1.471-11(c)(3)(ii)(*m*), (*n*).

[40] See supra, pp. 7–10.

STATEMENT OF WILBUR J. HOLLEMAN, CHAIRMAN, COMMITTEE ON CONTRACT ACCOUNTING, NATIONAL CONSTRUCTORS ASSOCIATION

Mr. HOLLEMAN. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, my name is Wilbur Holleman, and I am chairman of the Committee on Contract Accounting of the National Constructors Association.

This is a 35-year-old trade association of 57 national contractors and subcontractors. We have filed a very detailed statement also here today.

I personally have 25 years of intensive experience in taxation in the construction industry. I started out as a tax lawyer, but on a continuous basis I have had more exposure to construction activities than anything else and I am currently an executive of a construction company.

Our committee is a new committee because when the President's announcements were made last September or so, we didn't think he was after us because we had used this method since 1918. Regulations were issued almost 65 years ago with respect to building and construction contractors and over the last 64, 65 years, we have executed our taxes and paid them regularly on this method.

Now, you can say, well, that is a long time ago, has this just been hanging around for 64 years with nothing happening?

No; just a few years ago, in 1976, these regulations were refined and updated, and I think all significant problems were worked out. That was after a 5-year joint industry Treasury study. So it is our traditional method that has been updated.

Why does the completed contract method make sense for contractors? It works well because you pay tax or deduct a loss, when you know what happened, when your income has been realized. And furthermore, you have cash available at that time to pay the tax, because, as you know, it is traditional for owners to keep back part of the progress payments until they are satisfied with the work—so you know what your income is, and just as important, you have the cash with which to pay it.

Now the Treasury has various alternatives. One which Mr. Nolan talks about is a brand new invention which leads to taxation when you have no income, the progress payment method, and the other is the percentage of completion method which is totally based on estimates.

It is sort of one sided in that losses aren't necessarily given the same treatment that they would be on your final statements.

Now there also regulations. I think the Treasury feels they can't directly repeal this method for contractors by legislation because it has been around for 64 years. So what they are doing is gutting it.

One of the examples is the way in which these regulations are issued. They have taken ACRS away from contractors.

That is the practical effect of it, and Congress, of course, just enacted ACRS last year.

Now, accounting is an arcane and confusing subject, but it is where the action really is—in the details. And the details of those regulations when they are added up gut or emasculate completed

contract method accounting. We want to work with the committee and Treasury to curb any abuses that exist.

We are confident that they don't exist for contractors. We don't think the explanation is directed at us.

We don't think it is directed at an industry characterized by small companies, an industry characterized by even some economic distress in good times. For example, about 6.2 percent of the work force is in construction, according to the statistical abstract. However, despite the fact we have 6.2 percent of the work force, our business failures run 20 percent of total business failures.

In 1980 our unemployment rate in construction was 14.2 percent, which is exactly twice the national unemployment rate.

We are more concerned than anybody that the integrity of the completed contract method be retained because it is our method. We have used it for 64 years, if not longer. It makes sense. It is traditional. The problems have been worked out as far as our industry is concerned, and we think we should not only be allowed to use it, but be encouraged to use it.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF WILBUR J. HOLLEMAN, CHAIRMAN OF THE COMMITTEE ON CONTRACT ACCOUNTING, NATIONAL CONSTRUCTORS ASSOCIATION

SUMMARY

Mr. Chairman and members of the committee, my name is Wilbur J. Holleman, and I am pleased to have the opportunity to appear before you today. I am Chairman of the Committee on Contract Accounting of the National Constructors Association ("NCA"). Our Association has represented many of America's national construction contractors and sub-contractors for over 30 years. We presently have more than 50 member companies, who are engaged in building process plants and related facilities for electrical power generation; oil refining, chemicals and petrochemicals; paper, mining, steel and metals production and fabricating; and other processing and manufacturing needs here in the United States and abroad.

We strongly oppose the Treasury Department's proposals to abolish use of the completed contract method of tax accounting by the building and construction industry. As to our industry, the proposals are unfair and ill-conceived, and they must be rejected by the Congress:

The building and construction industry has used this method for 64 years (since the beginnings of the income tax in 1918) to accurately and fairly pay its taxes. It is the natural, historic and accurate way to compute income or loss from construction contracts.

The existing regulations represent the outcome of six years (1971-1976) of intense study and discussion by industry, the Treasury and Congressional staff to update and refine this traditional accouting method. These regulations are correct and valid as to our industry, and there is no policy justification for again changing these rules as to us.

The alternative accouting methods proposed by Treasury are unfair and deficient: the newly-invented "progress payment method" imposes tax on income that has not yet been realized, and the percentage-of-completion method imposes tax on estimates of future income when there is no cash available to pay the tax.

The completed contract method of tax accouting works equitably for the construction industry and is based on traditional and proven tax principles; it is not "an incentive" and it is not "abused" by our industry.

The Congress must protect the building and construction industry from Treasury's unwarranted attack by taking these actions:

The Treasury should be directed not to issue its unfair and invalid proposed regulations, which would effectively repeal our use of the method by administrative fiat. The courts have consistently held that the method has been approved by Congressional reenactment of the governing statute, and only Congress can decide what changes are in order.

Abuses by other industries, such as indefinite postponement of income, should be curbed by Congress to protect the integrity of the completed contract method of accounting. We offer suggestions as to how this should be done. We should not be forced to pay the price for tax abuses that may have been committed by other industries.

The Treasury legislative proposal to abolish use of the method by construction contractors should be rejected.

In these troubled economic times, the building and construction industry needs support, not discriminatory, unworkable and improper new tax burdens:

Our industry is characterized by small firms, with limited capital, operating on slim profit margins.

Many firms, large and small, are in danger of failing and cannot survive if their costs are substantially increased.

Damage to us will hurt the entire American economy, including increasing unemployment for our workers.

STATEMENT

Mr. Chairman and members of the committee, my name is Wilbur J. Holleman, and I am pleased to have the opportunity to appear before you today. I am Chairman of the Committee on Contract Accounting of the National Constructors Association ("NCA"). Our Association has represented many of America's national construction contractors and sub-contractors for over 30 years. We presently have more than 50 member companies, who are engaged in building process plants and related facilities for electrical power generation; oil refining, chemicals and petrochemicals; paper, mining, steel and metals production and fabricating; and other processing and manufacturing needs here in the United States and abroad.

Here is a brief picture of our industry, based on the most recent available data from the Commerce Department's 1981 Statistical Abstract of the United States: In 1977 there were 994,000 proprietorships, 69,000 partnerships and 216,000 active corporations involved in general building, heavy construction and special trades (*e.g.*, heating, air conditioning, electrical, etc.) in the United States. In 1980 we employed 6,065,000 workers (6.2 percent of the total U.S. workforce of 97,270,000) at an average hourly wage of $9.92. We put in place in 1980 new construction in the U.S. value at $230 billion. However, our unemployment rate in 1980 was twice the national average (14.2 percent compared to 7.1 percent), and 2,355 construction firms failed, constituting 20 percent of all U.S. business failures of 11,742. And the Wall Street Journal reported on Tuesday of this week, March 30, 1982, that the dollar amount of non-building new construction contracts dropped 43 percent in February compared to January, 1982, on a seasonally-adjusted basis.

When the Fall Budget Program was announced last September, the Treasury Department listed the "completed contract method" of tax accounting as one area under review "to eliminate abuses, remove obsolete incentives and enhance tax collections." We did not believe this review could conceivably affect our industry. The completed contract method is the natural and historic accounting method for clearly reflecting taxable income in our industry: Building and construction contractors have accurately and fairly computed their income and paid their taxes under this method since 1918. So far as we are aware, the Treasury Department has never before alleged that there are "abuses" in our industry or that our method of reporting constitutes an "incentive."

Thus, we were astonished when on February 18, just a month and a half ago, a draft of the Treasury's proposals was "leaked" to the press, and we saw that indeed we are a target of the proposals. The official General and Technical Explanation appeared on February 26. Given the Treasury's stated reasons for these proposals (discussed below), it is clear that the proposals should not apply to us. The completed contract method is not a "loophole" for builders and construction companies.

We believe that, as applied to our industry, the longstanding Treasury regulations which authorize the completed contract method are correct and valid. These regulations were first issued in 1918, and were updated and refined in 1976, following six years (1971–1976) of intense study and discussion by industry, the Treasury Department and Congressional staff. The 1976 regulations left the treatment of the building and construction industries substantially unchanged, but for the first time officially allowed certain manufacturers to use the completed contract method.

If there are abuses in the use of the completed contract method by other industries, as alleged by Treasury, we will support Congressional initiatives to preserve the integrity of the method. We make some suggestions at the conclusion of this statement. But we strongly oppose Treasury's attempt to preempt Congressional

consideration of this matter by unilaterally issuing proposed regulations which would effectively repeal the method by administrative fiat. Rather, Treasury should let Congress decide the matter. We are confident that once the facts are fully understood, the Congress will retain the completed contract method intact for our industry.

HISTORICAL BACKGROUND

The tax accounting treatment of building, installation and construction contracts has remained substantially unchanged for 64 years. In 1918 the Treasury Department first issued regulations authorizing use of the completed contract method by construction contractors, thereby recognizing that this method is the natural and traditional way to compute income or loss on construction contracts. See Reg. 33, Article 121 implementing the Revenue Acts of 1916 and 1917. The method has remained in effect for our industry since 1918, and the courts early on held that Congress had approved the method by re-enacting the governing statutory provisions. See, *e.g., H. Stanley Bent* v. *Commissioner,* 56 F.2d 99 (9th Cir. 1932).

The principal reasons for completed contract accounting for construction are: (1) it is the most accurate way of determining profit or loss for tax purposes from a specific construction contract, and (2) it meets the tax law requirement that income or loss must be "realized" before it is reported. No alternative method works as well. As the Treasury Department stated in 1970:

One of the reasons why permission to report on a completed contract basis is given in the case of building, installation, and construction contracts is the fact that there are changes in the price of articles to be used, losses and increased cost due to strikes, weather, etc., penalties for delay, and unexpected difficulties in laying foundations which makes it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed. Rev. Rul. 70–67, 1970–1 C.B. 117.

We note that some construction contracts, like some defense contracts, are priced on a cost reimbursable basis. These contracts contain major and substantial risks, such as described in the Treasury's 1970 ruling, since many costs are not reimbursable by the project owner but instead are borne by the construction contractor. The Internal Revenue Service has recognized that "cost-plus" contracts qualify for completed contract accounting. See Rev. Rul. 77–38, 1977–1 C.B. 129.

The Treasury regulations were most recently refined and updated in 1976. These changes were the product of a six-year (1971–1976) joint effort by industry, the Treasury, the Internal Revenue Service and the staff of the Joint Committee on Taxation. Congress was fully aware of this effort and of the fair and reasonable results which were achieved.

The 1976 regulations retained without substantial change the historic treatment of the building and construction industries. The regulations did, however, include one major change in the completed contract method: For the first time, certain manufacturers who engage in long-term contracts were officially permitted to use the method. Many of these companies work in the aerospace industry under extremely complex and lengthy contracts, and they simply do not have the construction industry's 64 years of experience in completed contract accounting. We cannot say whether it is now timely, only six years after the issuance of the 1976 regulations, to limit the use of the completed contract method by other industries. But it is clear that there is no rationale whatever for abolishing the method for our industry.

TREASURY'S "TWO-TRACK" PROPOSALS

The Treasury Department has offered a "two-track" proposal—both legislative and regulatory. The legislation would abolish the existing Treasury regulations, which without substantial change have authorized use of the completed contract method by our industry for 64 years. In addition, taxpayers who now account for long-term contracts on the cash or accrual methods would also be denied use of those methods. In place of the completed contract method, the cash method and the accrual method, taxpayers would be forced to choose between only two alternatives, the so-called "percentage of completion" method and a newly-invented and poorly thought out "progress payment" method. Both of these alternatives are vastly inferior to the completed contract method, since they require a contractor to report income on a transaction at a point in time before it is possible to determine whether there is income to report, i.e., at a time when no accurate determination can be made by anyone as to whether the contractor has a profit or a loss on his contract.

The important issue at this point in time is that the Treasury has asked for legislation. We agree that if the method is to be changed or abolished, then Congress, not the Treasury, is the proper forum to judge the issue. The regulations have a long history, and the courts have therefore held that Congress has approved the method by statutory reenactment. Treasury at this point is a contending party, and taxpayers must rely on the Congress for basic fairness. At the end of this statement, we offer suggestions for an alternative to Treasury's legislative and regulatory proposals, which we urge the Congress to consider.

However, the second track of the Treasury's effort is to promulgate regulations which, as applied to our industry, would make the method completely unuseable and would therefore have the effect, as a practical matter, of abolishing the method by unilateral, administrative fiat. We believe that such an administrative repeal would be legally invalid in view of the holding of the courts that Congress has approved the method by re-enacting the governing statutory provisions. Despite the court opinions, Treasury is now writing discriminatory proposed regulations which would effectively abolish the method by denying out industry current deductions for ordinary and necessary business expenses (such as pension contributions, interest on general corporate debt, corporate legal and accounting expenses, etc.) which every other industry in America takes for granted. This is patently unfair. Moreover, these proposed regulations, if issued, would usurp Congress's proper prerogative of reviewing this whole issue.

The legislative and regulatory proposals have the same effective date, taxable years beginning after December 31, 1982. They represent over-lapping and redundant approaches: the legislation would render the regulations moot, and as applied to the construction industry, the regulations would make the legislation irrelevant since the method would already have been effectively repealed. Thus, we believe that one purpose of the Treasury's two-track maneuver is to unfairly coerce affected taxpayers into negotiating a compromise with Treasury on its proposed massive changes in the regulations. We submit that this improper tactic represents an abuse of the regulatory process by the Treasury. As far as the building and construction industries are concerned, the Congress must not let Treasury's efforts succeed.

Why is the Treasury making these proposals? Although we suspect the real reason is to raise revenues, regardless of the obvious lack of basic fairness, intellectual coherence and practical administrability of the proposals, the stated reasons are as follows:

First is "conformity." The Treasury Department believes the completed contract method does not conform to "standard accounting practices." This simply is not true. The method is a well-respected, long-standing approach, which the courts have sustained on numerous occasions. See e.g., James C. Ellis, 16 B.T.A. 1225 (1929), where the Court held as follows:

It is true that returning income on the completed contract basis may result in a larger income in a given year than would be reported for the same year were the profit spread over the entire term in which the contract was performed. But it seems to us that the former method of returning the profit from a long-term contract is no more likely to result in distortion of income than the latter method. For example, a contract covering a period of two years may show a profit at the end of the first year based on receipts and expenditures at that time, whereas the contract when completed may result in a loss. The completed contract basis will always reflect the gain or loss from the contract as whole, while the other method may result in a gain being reported in one year when the contract terminates in a loss, or a loss being reported when a gain finally is realized.

Moreover, conformity with financial accounting methods has never been a determinative rationale in tax policy. As the Supreme Court recently stated in *Thor Power Tool Co.* v. *Commissioner,* 439 U.S. 522 (1979):

Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty.

A presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants long have recognized that "generally accepted accounting principles" are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions.

"Generally accepted accounting principles," rather, tolerate a range of "reasonable" treatments, leaving the choice among alternatives to management. . . . Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax. 439 U.S. at 544.

Finally, Treasury's proposed conformity is one-sided and inequitable. Treasury would like to require recognition of estimated income from a contract, prior to realization of that income upon completion of the contract, but apparently is unwilling to permit recognition of estimated losses. Financial accounting of course permits the recording of both gains and losses on an estimated basis.

The Treasury attempted to impose such "one-sided" conformity (only on the income side) by regulation in the early 1970's. See Prop. Reg. § 1.451-3 (March 24, 1971). Although that attempt was not nearly as radical and far-reaching as the present proposal, it was met by an outcry from the construction industry and by Congress, and it was quickly dropped by Treasury. Prop. Reg. § 1.451-3 (December 15, 1971). We should not now be rehashing the discredited conformity proposals of 10 years ago.

The second reason the Treasury gives for its proposals is that the completed contract method has led to large and unintended tax benefits. Treasury describes the problem as follows: "For instance, many contractors, including virtually all in the defense and aerospace industries, can sustantially reduce their current tax liability through the use of the completed contract method." Treasury points to unjustified deferrals of the date of completion of a contract (by as much as 15 or 20 years) and combining the completed contract method with inventory accounting. These problems do not exist in the construction industry. If there are abuses in other businesses, we believe better audit enforcement, rulings and possibly some regulatory changes can deal with the problems, and we would support such actions. Manufacturers under long-term contracts only began officially using the completed contract method in 1976; they simply do not have our 64 year history.

Finally, Treasury says, "Because of inflation and the increasing size of new contracts, the deductible costs will often exceed the income to be recognized (from old contracts) in any one year." This statement can apply, if it is true at all, only to contracts of exceptional duration (e.g. 20 years); such contracts would seldom if ever occur in our industry. Moreover, the building, installation and construction industries have computed their income and have paid their taxes under the completed contract method since 1918, in times of inflation and times of deflation. We see no justification for repealing this accounting method for our industry because of transitory swings in other industries which may benefit the Government one year and some taxpayers the next year.

The economic effects of the Treasury proposals on our industry will be severe. The building and construction industry is a risky business even in the best of times. But today, many companies are on the edge of survival. Constructors often operate on limited capital, and imposition of a new regime of tax accounting, with all the attendant uncertainty and costs, will strain their financial resources. Many companies will lose their competitive ability, and some will not survive. Jobs in the building, installation and construction trades will be lost. No one will benefit—not the industry, not the Treasury, and not America's economy.

TREASURY'S LEGISLATIVE PROPOSAL

The Treasury's legislative proposal would repeal the completed contract method altogether, and replace it (as well as replacing traditional cash and accrual accounting) with two alternatives—the percentage of completion method or a newly invented "progress payment" method.

We strongly oppose this legislation as applied to our industry. As described above, the traditional users of the completed contract method have paid their taxes fairly and equitably for 64 years. We see no reason to jettison that method now.

The two proposed replacement methods will produce unfair and, quite simply, incorrect results.

1. Percentage of completion method.—This method is based on pure estimates and therefore involves uncertainty and guesswork. The taxpayer is supposed to compute the ratio of costs incurred to date over estimated costs for the entire contract, and then multiply that ratio by the estimated gross contract price. Two out of the three factors are estimates and will inevitably lead to disputes and litigation between taxpayers and the Internal Revenue Service. This method will, in sum, cause "insurmountable difficulties of tax administration." See *Thor Power, supra.*

Further, it is common for the owner of a constructed facility to withhold retainage of say 10 percent from each contract payment. The accumulated retainage usually is payable to the contractor only upon final acceptance of the work and often exceeds the contractor's profit. Percentage of completion accounting gives no recognition to the adverse effect of retainage on the cash position of the construction contractor, and therefore this method often works improperly and unfairly. This is be-

cause percentage of completion requires the full estimated percentages of the contract price to be included in gross income without reduction for any percentage of payments retained by the owner. See e.g., R. Orino, 34 B.T.A. 726 (1936). The Treasury Explanation correctly notes that, "Requiring this method . . . may be difficult to administer and burdensome to taxpayers" and that another method "might not affect a taxpayer's cash flow as severely as would the percentage of completion method." The only other method that works, however, is the completed contract method

This is not to say that the percentage of completion method does not have significant advantages for a company's financial accounting statements. It permits reporting of estimated percentage earnings from contracts to be completed in future years to banks, other lenders, shareholders and bonding companies. It does not, however, reflect net income from a contract on a sound basis for purposes of the mandatory imposition of a cash tax liability.

We understand that the Treasury Department may attempt to deal with the problem of IRS attacks on percentage of completion estimates by proposing a safe haven rule (doubtless an inflexible rule in practice) that the taxpayer's estimates will be honored if the profit pick up ratios on a given contract to not exceed the profit pick up ratios experienced in the taxpayer's similar contracts for the three preceding years. This "safe haven" is meaningless. Both the accounting literature and common sense tell us that each contract is its own "experience" based on its unique facts. Conditions of every contract differ enormously, e.g. as to price, years to complete, site conditions, labor conditions, material shortages, inflation effects on individual parts of the job, etc. If there were any sort of inherent profit ratios in construction contracts, no contractor would ever have taken bankruptcy. Any such "safe haven" proposal by Treasury is nothing more than a flat admission that percentage of completion estimates are no more than guesses about which reasonable (or unreasonable) views can markedly differ. This method will simply lead to costly and lengthy disputes.

2. Progress payment method.—The Treasury's newly-invented "progress payment" method departs from all traditional theories of income taxation, since it would tax positive cash flow (including the amount of construction loans from the owner): It would not be a tax on profits. The method apparently requires costs to be deferred until income is recognized, but does not allow current deduction of costs even if income has previously been reported. The tax payments over the job bear no relation to payments based on traditional concepts of accounting for either tax or financial profits. This method is completely unprecedented in United States tax history, and we are unable to find anything remotely like it in the laws of any foreign country. It is unfortunate that Treasury has lost sight of the Constitutional requirement that only "income" may be taxed. We seriously question whether Treasury would regard the progress payment method as producing a tax on "realized net income," which would be entitled to the credit for foreign income taxes if imposed by a foreign country. See Temp. Reg. § 4.901-2(c).

In addition, under this method taxpayers could not set off current losses on one contract against profits on another. Losses would be allowed only to the extent of gross income for the year on the specific contract in question. This is obviously unfair and arbitrary. Companies often knowingly enter into loss contracts as "loss leaders" for market penetration. Denial of these losses has no precedent in tax policy.

Further, construction contractors frequently use "front end loading" (e.g., mobilization payments) or unbalanced bids to minimize needs for contract financing. Later payments to the contractors are appropriately reduced. The Treasury proposal fails to allow for what is in effect an owner advance or loan to the contractor. In addition, Treasury would tax direct loans from the owner or even from a third-party bank which are secured by the contract. Under Treasury's approach, a contractor would have to borrow $1.85 for each $1 of working capital he needs. ($1.85 − 46 percent $1.85 equal $1.) Taxing borrowed funds is contrary to the historic statutory and constitutional requirement of taxing only "income."

Moreover, the progress payment method may simply constitute a recognition by Treasury that retainage in long-term contracts causes the percentage of completion method to tax estimated income that is not represented by actual cash, so that the taxpayer may not be able to pay the tax. However, the progress payment method may be even worse than the percentage of completion method since it imposes tax on amounts which do not constitute income under any existing accounting method. Treasury has not squarely faced the fact that the completed contract method is the only fair and correct way to handle retainage. Finally, it could be inordinately ex-

pensive to develop and maintain progress payment records which could never be useable for any accounting purpose.

The replacement of completed contract accounting with the progress payment method is tantamount to tossing one's compass overbroad in the midst of a long trip in uncharted waters. Treasury itself seems uncertain on the rules, and every day or two a new rumor surfaces as to what Treasury will propose. However, no matter what ingenious devices Treasury invents, the progress payment method is inherently flawed and will not work. Therefore, construction contractors will not use it, and under Treasury's proposal we will be forced to use the percentage of completion method and foced to bear the cost burdens of estimating tax liability and paying taxes on cash which has not been received. We strongly urge the Congress to reject this ill-considered and improper proposal.

In sum, both these alternative methods have significant deficiencies. Neither is at all comparable to the completed contract method for tax accounting purposes, since only under this traditional method is tax imposed on realized amounts at a time when cash is available to pay the tax. There is no justification for repeal of the completed contract method for construction contracts and substitution of deficient alternatives.

TREASURY'S REGULATORY PROPOSAL

Treasury's regulatory proposal would in practical effect abolish the completed contract method for builders and construction contractors by denying deductions for ordinary and necessary business expenses which have never heretofore been questioned and which are specifically deductible under the 1976 regulations. We strongly oppose this indirect repeal of the method by administrative fiat.

Under the current Treasury regulations (section 1.451-3(d)), all "direct material costs and direct labor costs must be treated as costs properly allocable to a long-term contract." In addition, most indirect costs "which are incident to and necessary for the performance of particular long-term contracts" must also be allocated to the contract. These direct and indirect costs are deductible only when the gross income from the contract is included in income, i.e., in the year the contract is completed. The present regulations list 14 classes of indirect costs which cannot be deducted currently. These costs include repairs, maintenance, indirect labor costs including some fringe benefits, financial depreciation, administrative costs and officers salaries which are attributable to particular long-term contracts, etc. It is essential to understand that substantially all costs of performing a contract are allocated and deferred; they are not deducted currently.

General company expenses, however, which benefit the taxpayer's activities as a whole, or have been the subject of special Congressional action, are not required to be allocated to particular long-term contracts, but instead are deductible when incurred. These so-called "period costs" include marketing and selling expenses, interest, research and development costs, general administrative expenses (but not overhead specific to a particular contract), pension contributions and other items.

The Treasury proposes to drastically revise the existing regulations by requiring that all but certain insignificant indirect costs be allocated to long-term contracts (i.e., "capitalized") and deferred until the contracts are completed. The proposal states that the new regulations will require that "all indirect costs that directly benefit the performance of long-term contracts and an appropriate part of all other indirect costs must be allocated to long-term contracts." This statement indicates that some "appropriate part" of indirect costs must be deferred, even if such costs do not directly benefit the performance of the contract. This is a massive change from existing law under which indirect costs that benefit specific contracts are generally deferred, but those which only benefit the taxpayer's activities as a whole are deductible.

The proposal provides an extremely limited list of items which are excepted from the general rule of deferral. No rationale is given for including or excluding various costs. Comparing the proposal to the current regulations, it appears that the following indirect costs which are now deducted will have to be capitalized:

1. General and administrative expenses attributable to the performance of services which only benefit the taxpayer's activities as a whole (such as payroll expenses, legal and accounting expenses, etc.).
2. Interest.
3. Compensation paid to offiers attributable to the performance of services which only benefit the taxpayer's activities as a whole.
4. Qualified pension contributions to the extent they do not represent past service costs, and profit-sharing contributions and other employee benefits incurred on

behalf of labor, including workmen's compensation, non-qualified pension and profit-sharing contributions, premiums on life and health insurance, and other miscellaneous fringe benefits, such as medical treatment, cafeteria and recreation facilities, etc.

5. Depreciation and amortization reported for Federal income tax purposes (i.e., ACRS depreciation) in excess of depreciation reported by the taxpayer in his financial reports.

6. Research and experimental expenses directly attributable to particular long-term contracts in existence at the time such expenses are incurred or incurred under any agreement to perform such research or experimentation.

7. Percentage depletion in excess of cost depletion.

8. Marketing, selling and advertising expenses other than "general marketing, selling and advertising."

9. "Distribution" expenses (other than marketing, selling, bidding and advertising).

10. Bidding expenses incurred in the solicitation of contracts which are awarded to the taxpayer.

11. Costs attributable to rework labor, scrap and spoilage.

The existing regulations correctly treat these eleven items as deductible period costs. Thus, existing law allows both contractors and manufacturers to deduct two narrow categories of indirect expenses: category (1), costs which are not attributable to specific contracts and are therefore not susceptible of allocation to a particular contract, such as general administrative expenses, interest and salaries of officers not working on specific contracts; and category (2), costs of which Congressional policy favors immediate tax benefits, such as accelerated cost recovery (ACRS) in excess of financial depreciation, pension and profit sharing contributions and research and development costs. The determination of these "period" costs for current deductions reflected careful deliberation by prior Treasury officials over a six year period (1971–76). Each of them is as justified for the construction contractor as for the typical manufacturer and for the owner who does his own construction work.

The category (1) expenses (those of a general nature) are incurred on a regular, periodic basis, irrespective of whether the taxpayer is performing one, several or no long-term contracts during the particular period in question. Realistically, these expenses simply do not contribute to the performance of a particular contract, and they do not add value to the subject of the contract; rather, they relate to the taxpayer's business as a whole. These everyday expenses cannot be traced to particular contracts, nor would it be proper to allocate them among contracts based on some arbitrary, pro rata formula. Accordingly, current deduction is necessary in order to clearly and accurately reflect the taxpayer's income. There is no justification for attempting to capitalize ordinary and necessary business expenses.

For some of the items, it could perhaps be argued that in the most theoretical sense allocation is possible, albeit arbitrary; but even as to these items, attempting an allocation would be extremely impractical and imprecise. Complex and lengthy regulations will be needed. Large accounting and legal fees and costly record-keeping and paperwork burdens will be imposed on taxpayers, most of whom in the building and construction businesses are small companies operating on slim margins. Unnecessary and unproductive disputes and litigation will be the only possible result.

We understand that in an attempt to avoid such disputes, Treasury is considering regulations allowing "any reasonable method" of allocating ordinary and necessary business expenses to particular contracts. This is unacceptably vague. There is no "reasonable method" found anywhere in the accounting literature to accomplish this task, and absent definite, fair and understandable guidelines, Treasury's regulations will guarantee years of costly litigation. The Treasury Department has not yet found a reasonable way to avoid the significant administrative difficulties which this proposal will cause both to the IRS and to taxpayers, and we believe it will be unable to do so. If Treasury does somehow find a way to allocate general business expenses, the prescribed method should be applied equally to manufacturers and companies which self-construct projects, not just to construction contractors.

With respect to the category (2) expenses (those of a special nature), Congress has specifically determined that these expenses should be deductible and not be capitalized or deferred. As described below, the Internal Revenue Code expressly permits deductions for interest, research and development costs, pension contributions and other items in the Treasury proposal. Where these items are not to be currently deductible, the Congress has legislated specifically. See e.g., Code Section 189, concerning capitalization of construction period interest and taxes. Denying deductions for these costs by administrative regulation would, in effect, amend these explicit

statutory provisions and contravene Congressional approval of the historic treatment of these common business expenses.

Finally, this regulation proposal is extemely unfair and inequitable, in that it would impose these improper and unworkable regulations on construction contractors, while leaving manufacturers of goods free to continue to deduct period costs. The proposals would be in total conflict with the inventory capitalization rules applicable to manufacturers of goods. See Reg. § 1.471-11. Every expense to be capitalized by contractors under the Treasury proposal may be currently deducted by the typical manufacturer, as well as by persons who construct their own assets rather than contracting the work out. Moreover many manufacturers now benefit from quasi-permanent tax deferral through the use of LIFO ("last in, first out") inventory accounting elections. The proposal thus would creat a new and additional tax-law bias against contractors. The existing regulatory treatment of period costs was finalized by Treasury in 1976, for the purpose of "essentially restating the costing rules found in case and ruling authority." 41 Fed. Reg. 2636 (January 19, 1976). Equal treatment of contractors, owners, who self-construct and manufacturers of goods was a prime regulatory goal, which in large measure has been achieved. We cannot believe that conditions have so drastically changed since 1976 as to justify this proposed major policy reversal by Treasury.

In the light of these overall policy considerations, each item in the proposed list requires separate analysis.

1. General and administrative expenses.—General and administrative expenses conceptually do not contribute to the completion of particular contracts; instead, they are necessary to the business as a whole, regardless of the particular contracts currently in progress. However, it is important to emphasize that administration costs which are specific to a particular contract are capitalized under existing regulations.

As a practical matter, capitalization of general expenses cannot be reasonably accomplished. For example, how are the legal costs of general corporate housekeeping, such as writing the corporate minutes, to be allocated? How does one allocate the expenses of say an outside cleaning service which cares for the floors in the company's building? Clearly, the difficulty of the answers swallow up the question. And the unfairness is patent: Why are contractors being singled out to capitalize general and administrative expenses (as well many other everyday expenses) which every other business in America without a second thought?

2. Interest.—Interest constitutes a charge for the use of money over a particular period of time, and thus is the very essence of a period cost. The law is crystal clear that mandatory capitalization is improper. Section 163 provides specific authority for the deduction of interest, and section 266 provided that carrying charges, such as taxes and interest, may be capitalized only under limited circumstances and at the election of the taxpayer. The section 266 regulations recognize that interest is "otherwise expressly deductible," under section 163, and therefore that enactment of section 266 was needed in order to permit elective capitalization.

Treasury's proposal is inconsistent on this point. On the one hand, Treasury is attempting to require capitalization of interest, in the case of construction contractors (but not for typical manufacturers), by administrative regulation. On the other hand, it recognizes that capitalization of construction period interest by the corporate owner of a project can only be required by statutory amendment of section 189. If capitalization is statutory for owners, it should similarly be statutory for contractors. Congress would certainly not wish to legislate discriminatorily for one group, but let Treasury rule on its own for the other group.

Moreover, we believe it would be entirely impractical to attempt to allocate interest to particular contracts. The labyrinthine Treasury Regulations under section 861, dealing with allocation of deductions to U.S. source income, state that interest normally "relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore the deduction for interest should normally be apportioned on the basis of asset values." Reg. § 861-8(e)(2)(v). Costs in excess of billings on construction contracts are recorded on the balance sheet but are not assets in any real sense. Other assets used by a contractor—such as machinery and equipment—would be a very unreliable indicator, since labor is usually the principal component of construction costs. Moreover, the section 861 rules are exceedingly complex and difficult to understand (they took a decade to develop and contain four different approaches on interest), and application of these rules to thousands of construction contractors would create massive administrative problems.

How then would interest be allocated under the Treasury's proposal? Allocation based on "estimated" or "reasonably expected" income obviously could not be used,

since the basic principle of the completed contract method is that income or loss cannot reliably be determined in advance of completion. In any case, if Congress believes some allocation of interest is desirable, we believe that taxpayers must be permitted to trace borrowed funds to particular uses. For example, if a taxpayer incurred debt for the specific purpose of acquiring a subsidiary company not engaged in the construction business, then interest on that debt should be treated separately and remain currently deductible.

Moreover, there is the significant problem of treating parent-company debt in a controlled-group context. The section 861 rules are applied on a separate company basis, presumably because Treasury could find no reasonably way to "lookthrough" a complex corporate structure. How does Treasury propose to allocate parent-company debt to third-parties and intra-group debt between affiliated companies?

Many construction companies have more than one business activity (e.g., rental of idle equipment), so allocation within a single company would also be necessary. Moreover, even if the taxpayer were only in the construction business, interest would have to be allocated in some way to contracts completed in the year, since such interest would be currently deductible rather than deferred. Thus, even in the smallest construction business, impossible allocation problems would arise.

3. Officer's compensation.—It is rare that upper level officers work on a specific contract, but if one does, the current regulations clearly require allocation of salary to that contract and prohibit a current deduction. It is, however, difficult to justify allocation of compensation "attributable to the performance of services which benefit the long-term contractor's activities as a whole." For example, how can the salary of the Vice President for Taxes be allocated to specific contracts? His work involves corporate tax-planning and tax return preparation for the company as a whole. Will an hourly diary be required? We submit that any proposed allocation method will be arbitrary and unworkable. The fact of the matter is that the officers generally work for the betterment of the company as a whole and do not contribute to the performance of any particular contract.

4. Pension contributions and other fringe benefits.—Pension and profit sharing contributions have been recognized as legitimate period deductions for many years. For example, the Internal Revenue Service's ruling in I.T. 3408, 1940-2 C.B. 178, which authorizes pension deductions in connection with self-constructed assets, has been in effect for 42 years. Moreover, in its brief to the Supreme court in *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974), the Government admitted that pension costs which were specifically deductible under section 404 should not be capitalized. The Supreme Court agreed. See 418 U.S. at 17.

Fundamental national policy issues are at stake. The Code and ERISA contain complex, detailed rules for regulating and encouraging private pension plans. The rules regarding funding levels and benefit amounts are precise. These rules, built up over many years, are based on the premise that contributions are currently deductible. To eliminate current deductions for only one group of taxpayers is patently unfair and completely contrary to the thrust of many decades of pension policy.

The Treasury proposal would permit deduction of "past service" pension costs, but not of "current service" pension costs, all profit-sharing costs and related fringe benefits. The distinction between past and current service has no relevance to long-term contracts. The total past service amount is the total amount of funding which an actuary would have required to be in a plan to date had the plan always been in existence in its present form. That amount is then amortized over a period of years (usually 30–40), with the current year's contribution constituting the past service cost for that year. Current service cost on the other hand is the annual contribution which an actuary says would be necessary if the plan had always been in effect.

How can Treasury possibly use these difficult concepts to provide a fair and understandable allocation system? The fact is that pension contributions for any year fund benefits for employees for past years, the current year and for future years in order to provide a specified pension. Moreover, the contributions must be made without regard to how many contracts are in progress or which employees are working on which contracts. In addition, employees often leave employment before their pensions are fully vested. How would Treasury account for forfeited amounts which were allocated to completed contracts in prior years? Would the costs of the prior contracts have to be redetermined and the prior year's pension amounts reallocated to current contracts?

Finally, assuming that contributions are made currently (the only reasonable assumption), but not deducted during the life of a contract, how will Treasury treat the "bunching" of deductions in the year the contract is completed? A large deduction in the last year could easily violate the section 404 limitation of 25 percent of compensation. Indefinite carryforward means indefinite deferral of the deduction.

This will create a strong disincentive to maintenance of private pension plans in the building and construction industries.

Similar problems arise as to other fringe benefits covered by the proposal. The results approach the absurd. For example, how will Treasury allocate to particular contracts the cost of a company cafeteria or recreational facilities (both of which are specifically deductible under the existing regulations)? Will employers be required to keep daily records of which employee ate in the cafeteria or played softball on a company-provided field, how much he or she ate and the cost (or perhaps value?) of the benefit conferred? Why should construction contractors bear accounting and administrative burdens that no one else does?

5. ACRS depreciation.—The centerpiece of the Administration's 1981 business tax cut program was, of course, the Accelerated Cost Recovery System (ACRS), which significantly increased incentives for capital investment while greatly simplifying record-keeping and reducing disputes between taxpayers and the Internal Revenue Service. Now the Treasury proposes in effect to repeal ACRS for contractors, but not for other taxpayers, including manufacturers and those who do their own construction. Capitalization of ACRS accelerated depreciation will reduce investment and increase paperwork burdens. For whatever new equipment contractors do purchase, detailed records and complicated cost-accounting will be needed. If the Treasury believes ACRS is too generous (which we doubt), then it should scale it back on an even-handed basis for all taxpayers alike.

6. R. & D. costs.—Here too, allocation is impractical. Section 174 of the Code was enacted for the very specific reason that it was impossible to properly segregate and capitalize R&D in any context, and therefore complete deduction was needed. Why does Treasury believe capitalization will be any easier, or any fairer, as to long-term contracts compared with patents, self-constructed building projects, manufacturing, etc.? For example, suppose a construction and engineering company does research into the strength of certain metals to be used by it generally. A particular contract then is begun which requires special purpose metals, derived from the prior research. How will the research expenses be allocated?

In addition, capitalizing R&D would significantly impair the effectiveness of the R&D incentive provisions enacted in 1981, i.e., the R&D credit, exclusive domestic sourcing of R&D expenses and faster ACRS depreciation for R&D equipment. Moreover, the Congressional decision to end allocation of R&D expenses to foreign sources was based both on the incentive aspects and on the realization that the section 861 allocation rules are complex, difficult to administer and often arbitrary. Why is the Treasury now attempting to reverse the thrust of 1981 policy in this very important area for national growth? Why are contractors being put at a competitive disadvantage vis-a-vis manufacturers?

7. Percentage depletion.—It is difficult to say what Treasury has in mind here. We do not believe either percentage or cost depletion normally enters into construction contract work. Treasury may not approve of percentage depletion, but this is not the way to deal with that broader issue.

8. Non-general marketing, selling and advertising.—Marketing, selling and advertising are all ordinary and necessary expenses of doing business on a daily basis. By carving our "non-general" expenses, the proposal apparently attempts to require capitalization of costs which are somehow directly targeted or traceable to a particular contract.

Both conceptually and practically, this approach cannot be justified. The basic reason is that it is impossible to find a clear nexus between a particular marketing cost and a particular contract: the cause and effect relationship simply cannot be demonstrated. For example, marketing or advertising directed at the particular needs of one group of potential customers cannot be sensible allocated to the contracts which may or may not result. Much of the cost of any advertising campaign should probably be treated as a deductible loss in any event, since few potential customers ever become actual customers. Further, the campaign will have unintended "spillover" effects which are unrelated to the main effort; for example, the campaign may produce contracts with untargeted customers. How is any relationship to be determined? Moreover, a marketing program developed in connection with one effort will undoubtedly be used again and again at little additional marginal cost. Attribution of the initial costs solely to the first contracts produced would not be as logical as current expensing of the costs.

Thus, tracing of advertising costs to individual contracts is impractical, and pro rata allocation on some other basis (such as "expected" gross revenues or "expected" net profits) would involve distortion, unfairness and guesswork. The Treasury Department has not indicated how allocation would be accomplished, nor how costly litigation would be avoided. In sum, it has not justified its proposal.

9. Distribution expenses.—"Distribution" generally refers to certain expenses of manufacturers of goods rather than builders or construction companies: traditional contractors normally have nothing to "distribute." Yet manufacturers will be allowed to continue deducting their distribution costs. Moreover, even in the few cases where a contractor engages in distribution, it is very difficult to distinguish "distribution" from general marketing, selling, advertising and bidding. It is entirely unclear what the Treasury has in mind and why these vague and uncertain lines are being drawn.

10. Successful bidding costs.—In a theoretical sense, the cost of preparing a bid on a contract which is awarded to the taxpayer might be viewed as an acquisition cost of the contract. However, the Internal Revenue Service has itself rejected this view. In Revenue Ruling 56–136, 1956–1 C.B. 92, the Service considered the proper treatment of commitment fees or standby charges incurred by a taxpayer for the purpose of having credit made available when needed in connection with a construction project and preserving a firm price and interest rate for funds to be borrowed. The ruling holds that such costs are deductible business expenses in the nature of carrying charges, which may be deducted under Code section 162 or, at the election of the taxpayer, may be capitalized as part of construction costs. Such commitment fees are closely analogous to bidding expenses incurred in successful contract solicitations; in both cases, the costs are incurred for the purpose of obtaining a contract at a fixed price.

But even if there is a theoretical basis for allocating bidding expenses and the Treasury now wants to take a different view, in reality there is no consistent or acceptably precise way to do so. It is rare indeed that the expenses incurred in preparing a bid can be neatly or easily segregated and allocated to that bid. For example, the engineering and technical work which goes into a particular bid may have been done in a prior period in connection with several other projects or as part of the taxpayer's activities as a whole. The experties of a professional construction engineer, for example, has been built up over a lifetime of different work. As in the case of marketing and advertising, allocating bidding costs to particular contracts is unrealistic and unworkable.

11. Rework labor, scrap, and spoilage.—We do not understand Treasury's concern in this area. Spoilage of materials, for example, is often a company-wide problem which rarely affects a particular contract.

In sum, the present period cost regulations are well thought out, consistent and, in a word, correct. The Treasury Department should not be proposing unworkable allocation rules, thereby adding to taxpayers' already severe regulatory burdens. Further, Treasury should not be permitted to frustrate Congressional policy with respect to ACRS, R&D, etc. The Treasury regulation proposals can perhaps best be characterized as theories running amok in the blind pursuit of revenue.

This is not to say that existing regulations should not be expanded upon with respect to certain abuses identified by Treasury, such as the problem of several contracts being improperly treated as one contract or a single contract being extended indefinitely. These abuses, if they occur, do not occur in our industry. Moreover, period costs are not the problem: the existing regulations are logical, reasonable and reflect existing precedents, and they should be left as they were officially worked out in 1976. Nor is completed contract accounting for construction contractors a problem—it is logically justified and is the best method for arriving at profit or loss from a given contract. It is a method that has integrity for tax purposes because it ensures that only true income will be taxed and that cash will be available to pay that tax.

MINIMUM TAX PROPOSALS

Treasury's legislative and regulatory proposals include similar "transition" relief for contracts entered into on or before February 26, 1982, the date Treasury's General and Technical Explanations were officially released. Such "grandfathered" contracts can continue to be reported under the completed contract method, but costs deducted with respect to such contracts in taxable years beginning after December 31, 1982 will constitute preference items, subject to the proposed new corporate minimum tax.

We do not believe that February 26, 1982 is a fair or reasonable cut-off date. In light of the radical and sweeping nature of the Treasury's proposals, the genuine controversy and heated discussion which they have engendered and, particularly, the "shifting sands" of Treasury's own proposals for the "progress payment" method, we believe taxpayers cannot reasonably be expected to regard the February 26 date as of any significance.

More importantly, whatever the effective date, we see no reason for imposing a minimum tax. If a contract was entered into before the agreed on grandfather date, then what conceptual sense does it make to add on a minimum tax? How would such a minimum tax promote equity or fairness with regard to contracts entered into in good faith before the rules have been changed? We do not believe that reinventing the corporate tax in the guise of a new minumum tax can be defended either in general or in this specific situation.

If it should be proposed that existing period costs be retained, but subjected to the minimum tax, we seriously question the concept of "throwing" the minimum tax at every tax item that anyone has questioned, and specifically with regard to period costs which are either normal business expenses or Congressionally-favored incentives (ACRS, R&D etc.). The application of the minimum tax is especially suspect in this area, since Treasury's proposal would apply the tax even if the particular contract resulted in an overall loss.

In addition, it may be impossible for period costs to be determined as a basis for the minimum tax. For example, how does a construction contractor who also has a non-construction business calculate his period costs? If he has borrowed for general corporate purposes or for an office building, is the minimum tax intended to apply to all his interest expense? The same question can obviously be asked with respect to general administrative costs, etc. Further, a "period cost," even for a company that has only construction activities, is not a period cost if it somehow relates to a particular contract completing in the same year. Thus, the Treasury proposal on the minimum tax reflects as little understanding of the world of practical business affairs as the progress payment method.

CONCLUSIONS AND SUGGESTIONS

In summary, we do not believe the Treasury Department should take preemptive action by issuing proposed regulations while this issue is before the Congress. There is no policy justification for departing from the 1976 regulations so far as period costs of the construction industry are concerned, and the administrative problems would be immense. The proper forum at this time for resolution of the issues which Treasury has raised is the Congress.

Our industry will be happy to work with the Congress as it considers this important matter. We, as much as Treasury, want any abuses corrected. We, and apparently not the present Treasury, strongly believe in the integrity and correctness of the completed contract method, and we believe that, if necessary, any problems must be remedied so that it can be retained for us, its traditional users.

We believe the Congress should consider legislating in this area to preserve the completed contract method, but to correct abuses. For example, Congress could direct the Treasury Department to implement regulations specifying when two agreements can be aggregated and treated as one, and when one agreement should be severed and treated as two. Legislative direction could also be given as to when a contract should be deemed complete. If, as Treasury alleges, some companies are using completed contract accounting to pay tax-free dividends to shareholders, then Congress should direct Treasury to modify the earnings and profit rules on dividends. In addition, the Secretary could be instructed to study the problem further and correct whatever abuses he finds, provided that the traditional use of the method for building, installation, construction and similar contracts is not impaired. None of these changes, however, should put contractors at a disadvantage vis-a-vis manufacturers or owners who construct their own projects. None of the changes should be made effective except with fair and equitable transition relief, and without the added confusion and complication of a minimum tax.

Finally, the National Constructors Association believes that members of this Committee should direct the Treasury Department to desist from its unilateral attempt to abolish the completed contract method by making massive, invalid changes in its own regulations. Further, we hope we have convinced this Committee that our industry reports its income and pays its taxes as accurately and fairly as any other industry. Whatever the exigencies of the situation with respect to the need to raise revenues, there is no justification for discriminatory treatment of the building and construction industry.

Chairman ROSTENKOWSKI. Mr. Johnson, you may proceed.

STATEMENT OF H. GREGORY JOHNSON (PRESIDENT, JOHNSON ELECTRIC, INC., KEENE, N.H.), CHAIRMAN, NATIONAL LEGISLATIVE COMMITTEE, ASSOCIATED BUILDERS & CONTRACTORS, INC., ACCOMPANIED BY MICHAEL M. SCHOOR, DIRECTOR, GOVERNMENT RELATIONS

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. Chairman, I am Gregory Johnson, president of Johnson Electric, Inc., of Keene, N.H., and national legislative committee chairman of the Associated Builders and Contractors, Inc. Appearing with me today is Michael M. Schoor, ABC's director of government relations.

ABC is a national construction industry trade association representing 17,000 firms nationwide. The members of ABC believe in the "merit shop" philosophy, a concept which calls for open competitive bidding with contract award to the lowest responsible bidder.

I thank the committee for this opportunity to present our views concerning the administration's revenue proposal in the fiscal year 1983 budget to eliminate the completed contract method of accounting for income tax reporting.

Associated Builders and Contractors opposes the administration's proposal to eliminate the completed contract method. Such a proposal would be devastating to the construction industry and the national economy, having both fiscal and monetary effects. I would briefly like to summarize the proposal, explain the concerns and unique features of the construction industry, and describe the impact of the proposal on the industry and the economy.

The administration's legislative proposal would repeal the completed contract method and provide that taxpayers must elect to either use the percentage of completion method or the progress payment method of accounting for long-term contracts.

The progress payment method would be a new means of reporting taxable income. This method would tax positive cash flow independent of any reference to concurrent liabilities. Internal progress payments would be taxed as income, yet they include little or no profit and do not relate to the cost of the work permitted because of various cash flow management practices unique to the construction industry.

Advance and mobilization payments are the rule, not the exception, in the construction industry and are used for purposes which do not result in offsetting tax deductions due to the type of expense for which the cash is used; for example, collateral for lines of credit.

We feel that the proposed progress payment method is flawed since it would tax receipts when in fact nothing has been earned. It would treat each contract as a separate entity requiring the payment of taxes on contracts with positive cash flow while disallowing a reduction in taxes for contracts of negative cash flow, causing a severe financial strain on our members.

In addition to the administration's legislative proposal the current tax regulations for accounting for long-term contracts would be amended to require that, in the case of contracts accounted for by the completed contract method, all but a limited list of indirect

costs would be allocated to long-term contracts and deferred until such contracts are completed.

Revision of the period costs, as proposed in Treasury's technical explanation, would not reflect the realities of the construction industry. Many of these expenses simply do not contribute to the performance of a particular contract but relate to the firm's business expenses as a whole.

Certain common expenses cannot be attributed to particular contracts or even be allocated to long-term contracts by percentage or formula.

Such a practice would prove to be arbitrary and be an accounting nightmare.

Interest, general administrative expenses, and accelerated depreciation are three of the major costs which are impossible to allocate to given long-term contracts since they are used for general working capital and purchase of thousands of pieces of equipment that may be applied to a variety of projects.

The construction industry has been permitted the use of the completed contract method of accounting since the implementation of the Federal income tax in 1918.

Distortions in the use of the completed contract method are not evident in the construction industry. The distortions that are evident by other users of the method could be limited by providing a basis for severing long-term production contracts by units of delivery and acceptance or similar arrangement without simultaneously penalizing the construction industry's use of the method.

The method was designed for the unique aspects of the construction industry. If other industries or other period costs are undermining this method of taxation they should be addressed specifically.

Cash flow is most important for contractors because of the working capital demands of ongoing projects. For example, material, labor, and equipment. As a result, the construction industry has become reliant upon the completed contract method for the use of working capital to overcome constraints on their liquid assets inherent in construction industry practices.

In addition, contractors' liquidity is most important in their pursuit of new work since it is reflected in the net assets which determines the firm's bonding capacity.

Another strain on the contractors' cash flow management unique to the construction industry is the practice of retainage. Virtually all construction contracts have retainage provisions which normally withhold 10 percent of the contract price completed to date until after the project is completed.

Consequently, the profit element of which the retainage normally makes up a large part is not received or realized until the retainage is released. Furthermore, the contractor is losing interest on the amount being retained by the payer, further decreasing his profitability.

This constraining element is a key factor in demonstrating how important maximum cash flow is to the construction industry. Yet elimination of the completed contract method would tax not profits, but this positive cash flow, so vital to the contractor today.

The elimination of the completed contract method of accounting would have a definite negative ripple effect on the national economy. The proposal would create both fiscal and monetary problems which this Nation cannot afford.

The primary reason for the administration's proposal to repeal the completed contract method is the theory that this proposal will produce substantial new Federal revenues.

However, actual revenues generated would be much lower than currently anticipated. In fact, it is likely that the Federal Government would lose net tax revenue and probably incur billions of dollars in additional expenditures for increased construction costs and unemployment compensation as a result of this proposal.

Federal revenues would actually be lost from increased tax deductions for interest payments from increased borrowing. Elimination of the completed contract method would force contractors to borrow in order to finance operations formerly financed by tax deferred liabilities and advance payments.

In some cases, a firm's additional borrowings plus interest costs would increase their current operating costs by more than 100 percent.

The compounded costs of additional borrowing, additional taxes and higher interest rates will surely drive the marginally profitable small contractor into bankruptcy, decreasing the national tax base.

Higher interest rates, higher unemployment, higher Federal deficits, and less competition are the key components of a weak economy. Repeal of the completed contract method of accounting would create all of these conditions.

We ask you, how can you produce a vibrant and growing economy when faced with these obstacles? The administration is in error when it thinks the completed contract method simply defers taxes for construction firms.

Eliminating this method would make all taxpayers bear the burden for depriving this capital intensive industry the very lifeline of its existence. Eliminating the completed contract method would smother new business starts, strangle small contractors already hurt by the recession and stagnate the economy with inflationary and higher deficit trends.

Mr. Chairman, I respectfully request that you consider the plight of the construction industry and its unique risk and capital requirements before you act on this devastating revenue proposal. Associated Builders and Contractors strongly urges the administration and the Congress to retain the completed contract method of accounting with regard to long-term construction contracts.

[The prepared statement follows:]

STATEMENT OF H. GREGORY JOHNSON FOR ASSOCIATED BUILDERS AND CONTRACTORS

Mr. Chairman, I am Gregory Johnson, President of Johnson Electric, Inc. of Keene, New Hampshire and National Legislative Committee Chairman of the Associated Builders and Contractors, Inc. (ABC). Appearing with me today is Michael M. Schoor, ABC's Director of Government Relations. ABC is a national construction industry trade association representing 17,000 firms nationwide. The members of ABC believe in the "merit shop" philosophy, a concept which calls for open competitive bidding with contract award to the lowest responsible bidder. I thank the committee for this opportunity to present our views concerning the Administration's revenue

proposal in the FY 1983 budget to eliminate the completed contract method of accounting for income tax reporting.

Associated Builders and Contractors opposes the Administration's proposal to eliminate the completed contract method. Such a proposal would be devastating to the construction industry and the national economy, having both fiscal and monetary effects. I would briefly like to summarize the proposal, explain the concerns and unique featues of the construction industry, and describe the impact of the proposal in the industry and the economy.

THE PROPOSAL

The Administration's legislative proposal would repeal the completed contract method and provide that taxpayers must elect to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. In addition, the cash and accrual methods could no longer be used. Elimination of the cash and accrual methods from use by the construction industry appears to be arbitrary and punitive since they will still be available to other taxpayers.

The percentage of completion method is a most complicated and uncertain manner for reporting income due to the inability to accurately estimate income on a construction project. The taxpayer must compute the ratio of costs incurred to date over estimated costs for the entire contract. This method would tax excess billings but would not allow an offset for excess costs. Advance and mobilization payments are the rule, not the exception, in the construction industry and are used for purposes which do not result in offsetting tax deductions due to the type of expense for which the cash is used, e.g. collateral for lines of credit. Therefore, this method is not appropriate for the construction industry since early revenues are not proportional to offsetting expenses; and, the difficulty in calculating estimated profit until a construction project is completed is immense.

The progress payment method would be a new means for reporting taxable income. This method would tax positive cash flow independent of any reference to concurrent liabilities. Interim progress payments would be taxed as income, yet they include little or no profit and do not relate to the cost of the work performed because of various cash flow management practices unique to the construction industry.

We feel that the proposed progress payment method is flawed since it would tax receipts when, in fact, no income had been earned. It would treat each contract as a separate entity, requiring the payment of taxes on contracts with positive cash flow while disallowing a reduction in taxes for contracts with negative cash flow, causing a severe financial drain on most of our members.

In addition to the Administration's legislative proposal, the current tax regulations for accounting for long-term contracts would be amended as follows:

To require that, in the case of contracts accounted for by the completed contract method, all but a limited list of indirect costs would be allocated to long-term contracts and deferred until such contracts are completed.

To clarify when an agreement, or series of agreements, should be regarded as more than one contract.

To specify that, where the taxpayer uses the accrual shipment and accrual acceptance methods of accounting for multi-unit contracts, income accrues upon the shipment or acceptance of various units and not upon the final unit.

To require that, where the taxpayer is entitled to use an inventory method for a long-term contract, such taxpayer must use the costing rules set forth in the completed contract regulations.

The regulatory changes most affecting the construction industry are those affecting the allocation of indirect costs. In 1976, the Treasury Department made an equitable and appropriate decision on which indirect costs could be considered as "period costs" and deducted currently. A wholesale revision of the period cost deductions is not necessary or warranted.

Revision of the period costs, as proposed in Treasury's technical explanation, would not reflect the realities of the construction industry. Many of these expenses simply do not contribute to the performance of a particular contract but relate to the firm's business expenses as a whole. Certain common expenses cannot be attributed to particular contracts or even be allocated to long term contracts by percentage or formula. Such a practice would prove to be arbitrary and be an accounting nightmare. Interest, general and administrative expenses, and accelerated depreciation are three of the major costs which are impossible to allocate to given long-term contracts since they are used for general working capital and purchase of thousands of pieces of equipment that may be applied to a variety of projects.

Costly record-keeping and paperwork burdens and accounting and legal fees will be incurred by the taxpayers, most of whom are small construction businesses with already narrow profit margins. It is simply not fair that the construction industry should bear this drastic change when it has maintained a consistent tax accounting method for 64 years. If other industries or other period costs are undermining this method of taxation, then they should be addressed specifically.

CONCERNS AND UNIQUENESS OF THE CONSTRUCTION INDUSTRY

The construction industry has been permitted the use of the completed contract method of accounting since the implementation of the federal income tax in 1918. Distortions in the use of the completed contract method are not evident in the construction industry. The distortions that are evident by other users of the method could be limited by providing a basis for severing long-term production contracts by units of delivery and acceptance or a similar arrangement, without simultaneously penalizing the construction industry's use of the method. The method was designed for the unique aspect of the construction industry.

To require the payment of taxes on contracts with positive cash flow while disallowing a reduction in taxes for contracts with negative cash flow is not only discriminatory against the construction industry but deviates from all traditional theories of business entity taxation (i.e. taxation of profits without any reference to concurrent liabilities). Furthermore, the explanation are based on erroneous assumptions. Such payments are subject to repayment by reduced progress payments during the term of the contract. These payments are not to be considered income, and taxing contract advances is tantamount to taxing working capital loans.

Cash flow is most important for contractors because of the working capital demands of on-going projects, i.e. material, labor and equipment. As a result, the construction industry has become reliant upon the completed contract method for the use of working capital to overcome constraints on their liquid assets inherent in construction industry practices. In addition, contractors' liquidity is most important in their pursuit of new work since it is reflected in the net assets which determines the firms' bonding capacity. Another strain on the contractors' cash flow management, unique to the construction industry, is the practice of retainage. Virtually all construction contracts have retainage provisions which normally withhold ten percent of the portion of the contract price, complete to date, until after project completion. Consequently, the profit element, of which the retainage normally makes up a large part, is not received or realized until retainage is released. Furthermore, the contractor is losing interest on the amount being retained by the payor, further decreasing his profitability. This constraining element is a key factor in demonstrating how important maximum cash flow is to the construction industry. Yet, elimination of the complete contract method would tax, not profits, but this positive cash flow so vital to the contractor.

Other physical and variable risks unique to the construction industry are: differing site and soil conditions, climate conditions, firms prices for the duration of the contract which require the contractor to bind himself to an unalterable price before actual costs are known, changes, modifications or claims during the course of the contract which require the contractor to expend large sums in advance of his contractual right to collect from the owner, intense competition within the industry which forces profit margins to be exceedingly small in relation to the total gross contract amount, and many others. Given these risks, the construction contractor cannot determine his actual profit until completion of the particular contract. It would be unfair to have a program payment method which taxes the very cash flow the contractor may need to complete the contract in order to recoup his losses or obtain final payments.

Bonding is a requirement that limits contractors to work on projects only up to the amount of their net assets in order to ensure adequate performance. This is another feature unique to the construction industry. A bonding company considers net worth and working capital in determining the amount of work a contractor can perform. The bonding company also considers deferred taxes not to be paid in the current year as a reduction in current liabilities, therefore increasing working capital. Therefore, the elimination of the completed contract method would have drastic reductions in the contractors' working capital and net assets used to determine their bonding capacity. The effect would be a severe reduction in the amount of work a business could pursue. Some of our members have indicated that elimination of the completed contract method would reduce their bonding capacity by as much as 50 percent.

Use of the progress payment method would create a greater tax liability and vast increases in borrowing. It would result in increased bankruptcies and increased operating costs of surviving firms. The proposed progress payment method would create an immense administrative burden, necessitating the creation of an entirely new set of books for tax purposes. The increased bankruptcies, resulting from increased borrowing, and reduction in bonding capacities will cut the competition throughout the construction industry. This would have a grim effect on the national economy.

IMPACT ON THE INDUSTRY AND THE NATIONAL ECONOMY

We have already mentioned several impacts on the construction industry which would emanate from the elimination of the completed contract method of accounting. There would be a definite negative ripple effect on the national economy. The proposal would create both fiscal and monetary problems which this nation cannot afford.

The primary reason for the Administration's proposal to repeal the completed contract method is the theory that this proposal will produce substantial new federal revenues. However, actual revenues generated would be much lower than currently anticipated. In fact, it is likely that the federal government would lose net tax revenue and probably incur billions of dollars in additional expenditures as a result of this proposal.

There are many factors, which I will soon discuss, which would lead to further unemployment in the construction industry—a sector which already has an umployment rate in excess of 18 percent. Federal outlays for unemployment compensation would escalate as more construction firms go out of business or drastically reduce their scope of business. Bankruptcies of construction firms cause economic burdens on suppliers and creditors, who must absorb such losses, and on the federal government, which faces costs in excess of 20 billion dollars for every one percent increase in unemployment.

Federal revenues would actually be lost from the increased tax deductions for interest payments from increased borrowing. Elimination of the completed contract method would force contractors to borrow in order to finance operations formerly financed by tax deferred liabilities and advanced payments. In some cases, firms additional borrowing needs plus interest costs would increase their current operating costs by more than 100 percent. The compounded costs of additional borrowing, additional taxes, and high interest rates will surely drive marginally profitable small contractors into bankruptcy, decreasing the national tax base.

Increases in borrowing by the construction industry, of the magnitude being discussed at today's high interest rates, would have a staggering impact on our financial markets. The projected demand for short and long term loans to finance operations would definitely exert an upward pressure on interest rates. Higher interest rates would have a tendency to increase bankruptcies, stimulate umemployment, and increase construction costs for those remaining contractors.

The elimination of the completed contract method would result in greater federal expenditures through increased costs for direct federal and federally-assisted construction projects. Increased costs would affect private construction as well and have a definite inflationary trend on the general economy. Increased construction costs would result from: higher interest rates generated by increased borrowing to cover working capital and deferred tax decreases, and less competition created by increased bankruptcies and firms having reduced bonding capacity due to lower net assets. It is only natural for firms with limited capital resources to increase their prices, or pass such costs on to the consumers, when faced with increased debt and expensive financing of that debt.

Higher interest rates, higher unemployment, higher federal deficits, and less competition are the key components of a weak economy. Repeal of the completed contract method of accounting would create all of these conditions. We ask you, how can you produce a vibrant and growing economy when faced with these obstacles? The Administration is in error when it thinks the completed contract method simply defers taxes for construction firms. Eliminating this method would make all taxpayers bear the burden for depriving this capital-intensive industry of the very lifeline of its existence. Eliminating the completed contract method would smother new business starts, strangle small contractors already hurt by the recession, and stagnate the economy with inflationary and higher deficit trends.

Mr. Chairman, I respectfully request that you consider the plight of the construction industry and its unique risks and capital requirements before you act on the devastating "revenue" proposal. Associated Builders and Contractors strongly urges

the Administration and the Congress to retain the completed contract method of accounting with regard to long term construction contracts.

Thank you.

Chairman ROSTENKOWSKI. Thank you.

Mr. Wilkinson, you may proceed.

STATEMENT OF ROBERT L. WILKINSON, PRESIDENT, ASSOCIATED SPECIALTY CONTRACTORS, INC., ACCOMPANIED BY JOHN HALECKY, JR., EXECUTIVE VICE PRESIDENT, L. K. COMSTOCK & CO., INC., DANBURY, CONN.

Mr. WILKINSON. I am Robert Wilkinson, president of the Associated Specialty Contractors, Inc. This is an umbrella organization of eight major associations of specialty and subcontractors, the large majority of which are very small businesses, under $5 million by our definition.

We have in the segments of the industry we represent about 165,000 construction firms doing about $63 billion worth of business, with 1,300,000 employees.

The main point I want to make, and then I am going to ask the gentleman, Mr. Halecky, accompanying me, to describe the effects of this on his own business, I do want to make the point that although Mr. Halecky's business is a large specialty contractor, that a very large number, perhaps 50 percent, of the small contractors would be equally affected.

The nature of the industry is that very small specialty contractors are on a construction job for 2 to 3 years, virtually from the beginning to the end in many cases, and their cash flow is being interrupted the same as the larger contractor, causing greater difficulty in the case of a small contractor.

Mr. Halecky, would you explain your conditions, please.

Mr. HALECKY. Mr. Chairman, I am John Halecky, Jr. I am executive vice president of L. K. Comstock & Co. We are electrical contractors, headquartered in Danbury, Conn., and operating around the country through regional offices located in New York City, Pittsburgh, Atlanta, Chicago, and San Francisco.

The company was founded by a pioneer of the industry, Louis K. Comstock, and is principally involved in major utility, commercial, industrial and transportation projects.

Since its inception in 1904, the company has used the completed contract method of accounting for both tax and book reporting.

On learning of the administration's proposed 1983 tax changes, our internal accounting staff was instructed to investigate their impact on the company. Senior management also met with the company's independent auditors and its advisers from the financial community to assess their understanding of the problem.

After thoroughly assessing the collective findings, we have concluded as follows:

The use of the progress payment or the percentage of completion methods might result in the acceleration of tax collections temporarily, but will not provide new taxes.

In fact, the proposed reporting methods will produce less tax dollars arising from the need of additional financing of contracts and of the lost opportunity of cost returns under the deferred contracts.

The cost of servicing additional debt will be passed on to Government agencies and will be an onus in the private sector through higher prices when bidding for these contracts, the ultimate effect again being decreased tax dollars.

With the need to incur additional debt, acknowledging that many major construction projects require a significant capital investment, the company would encounter difficulty in securing the support of the surety and banking sector which it and all construction companies desperately need.

The implementation of either the progress payment method or the percentage of completion method for taxes would require additional staffing, again ultimately resulting in less tax dollars.

In addition, it would make the auditing task of the revenue agent extremely difficult.

Most construction contracts provide for retention. That is the holding back by the owner of a portion of each progress payment, usually at the rate of 10 percent. Contractors in preparing a bid estimate include along with direct and indirect costs a markup of some 1 to 5 percent, depending on the competitiveness of the bid. The owner holds the retention pending final completion and acceptance of the contract.

Therefore, the contractor does not have his profit in hand if there is any profit until this release is accomplished.

With an annual sales volume in excess of $200 million, our company usually has approximately 400 open contracts. A good number of these contracts have a duration of 1 year or less.

Most of the remainder are 1- to 3-year categories. And the remaining contracts are for periods in excess of 3 years.

Longtime contracts have a high degree of uncertainty. In the early years, profit projections are common. But in later years, with delays and changes constantly occurring, profit projections slowly disappear and the final outcome is very difficult to ascertain.

Requests for changes to the contract and claims, which at times must be settled by litigation, are common before final close out and the ultimate profit determination.

We are sympathetic to the problems faced by this committee, the rest of the Congress, and the administration in attempting to cope with a nonresponsive economy and to limit the amount of projected deficits in the ensuing fiscal years. It is our belief that the present regulations contain the needed fundamentals, with some minor revisions, to achieve a more timely collection of taxes without any decrease in the ultimate amount of tax dollars.

The completed contract method must be maintained, with reporting required for each contract segment. And classification of the present regulations to define how a taxable segment is determined will serve to speed up tax collections and concurrently assist revenue agents in their auditing duties.

Our company strongly recommends that the present reporting methods be kept intact, and we maintain that the proposed changes will have a disastrous effect on us, the entire construction industry, and ultimately on the revenues collected.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT L. WILKINSON AND JOHN HALECKY, JR., ON BEHALF OF THE ASSOCIATED SPECIALTY CONTRACTORS, INC.

Mr. Chairman, my name is Robert L. Wilkinson, and I am appearing today as President of the Associated Specialty Contractors, Inc. ("ASC"), ASC is an "umbrella" organization of eight national associations [1] of construction specialty employer contractors. The segments of the construction industry represented by ASC affiliates consist of about 165,000 business establishments with annual sales of about $63 billion and 1,300,000 employees. The large majority of these firms are small business enterprises. Appearing with me today is Mr. John Halecky, Jr., Executive Vice President of the L. K. Comstock and Company, Inc. of Danbury, Conn. and New York City, a specialty contractor.

We are appearing today to express the vigorous opposition of the Associated Specialty Contractors to the elimination or significant modification of the completed contract method of tax accounting which has been permitted for construction contractors since 1918.

You have heard and will hear many arguments favoring the completed contract method of accounting for tax purposes and explaining the devastating effects of such a change in the construction industry, which has been using completed contract accounting for 64 years. Although we confirm their validity, we will not burden you with unnecessary duplication of these arguments. However, the impression is often conveyed that elimination of completed contracts accounting would affect only a relatively few large business concerns. This definitely is not the case. Even very small specialty and subcontractors often are engaged on construction projects of two or three years' duration. Although the dollar volume of some subcontractors' work on such contracts may not be large, the nature of contruction work requires many specialty contractors remain engaged from near the beginning to the completion of projects. Final payment is seldom received by any of the contractors or subcontractors until several months after final completion and settlement of various claims, disputes, and change orders.

The Treasury Department's proposals would have a serious impact on large contractors. It probably would have an even greater impact on many smaller contractors because they have relatively limited financial resources and borrowing capacity. Cash flow problems are great in the construction industry and already are causing a substantial number of failures. Profit margins are very low, generally half those in other types of business or even less, and risks are great. Construction contractors never know until all work is completed, claims settled, and final payments made whether they have made a profit or not. In many cases, pending losses on contracts are not evident until the last few weeks or months of the project. Often losses cannot be ascertained until it is determined whether settlement of claims for change orders and various damages will be favorable or unfavorable. Contractors are committed to complete specified work within a given time for a contracted sum of money and must estimate the amount of materials and labor that will be needed to complete such work over a period of several years and how much such labor and materials will cost them at the time they make payments. It is obvious that this is a difficult task, especially during times of inflation. Wages paid by many contractors increase as frequently as every six months. It is only on rare occasions that the actual wages which will be required throughout the job can be predicted accurately at the time of submitting bids.

Meanwhile, however, the severe competition that exists among contractors forces those who want to be awarded contracts in order to stay in business to make their bids optimistic, often excessively so, in terms of their cost projections. The truth dawns slowly, generally in the latter phases of the job, when inflation has greatly increased costs from the time the job was bid, when the contractor becomes aware of the amount of work still to be performed after various inevitable delays, and when this work has become increasingly costly to perform because of congestion at the work site and access to spaces where the work must be performed has become severely restricted.

Dun and Bradstreet statistics indicated a 70 percent increase in the first half of 1981 over the first half of 1980 in the number of total failures of building subcontractors. This happened despite a record year for bankruptcies in the 1980 because

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[1] Mason Contractors Association of America, Mechanical Contractors Association of America, Inc., National Association of Plumbing, Heating and Cooling Contractors, National Electrical Contractors Association, National Insulation Contractors Association, National Roofing Contractors Association, Painting and Decorating Contractors of America, and Sheet Metal and Air Conditioning Contractors National Association, Inc.

of cash flow problems, significantly decreased construction volume, high interest rates and inflation. The number of failures since the first half of 1981 probably have been even greater than during that half. A week ago Washington news media reported that Riggs bank lost $5.1 million in interest during 1981 because of late payments on loans by building contractors. More than $104 million in past due loans were held at the end of the year.

We acknowledge, of course, that none of these present conditions have been brought about by the inability of construction contractors to use the completed contracts method of tax accounting since the method is now being used. They do illustrate the severity of the construction industry's cash flow problem, however, and indicate that elimination of the completed contract method would very likely precipitate many more failures of construction contractors who are already having financial problems and who can ill-afford to pay today's interest rates to borrow working capital and money to pay taxes on interim revenues that may have no relation to an accurate representation of profit. It seems unconscionable to us for the government to bring about even more wide-spread failures of business firms by changing the method of tax accounting which has been in effect for 64 years. It is not only unconscionable; it is poor economics. The government will receive no additional tax revenue since these contractors already are paying tax on whatever profits there might be after the profits become known, following completion of the contract. Although the government might receive payments a little earlier, this would be at the expense of large amounts of borrowing by contractors, at interest rates substantially higher than the interest rates paid by the government. When interest payments are deducted from contractors' taxable income, the net effect might be less eventual tax revenue. Competition in the construction industry will be significantly curtailed because many contractors have borrowed to the maximum extent of their capacity, and will either be forced out of business or into severe curtailment of their operations. Contractors in financial difficulties or with excessive debt are unable to secure surety bonds and, thus, are unable to compete. A change in the accounting method also will result in substantial added accounting costs. It is obvious that the costs of construction will increase significantly, including construction for all levels of government and for all private owners, when competition is reduced and when contractors must allow in their bids for additional interest on money borrowed for working capital and to pay taxes and those higher accounting costs. The nation can ill-afford this ultimate effect of increased construction cost, lowered productivity, reduced competition and diminished tax base.

To indicate the extent to which contractors of various sizes would be affected, one of our affiliated associations, the Sheet Metal and Air Conditioning Contractors National Association, recently completed a survey of its membership, the large majority of which are small business concerns. Fifty percent presently use the completed contracts method of accounting. All of the remainder do not necessarily use the percentage of completion method which would be one of the two methods allowed by the proposals of the Treasury Department because many small contractors use cash or accrual accounting. These also would be disallowed. Probably none use the "progress payment" method suggested by the Treasury Department. Contractors who have never used the percentage of completion method and who do not have the technical and accounting personnel needed to estimate percentages of completion nonetheless would be forced to use this or the progress payment method. The latter is untried and novel, and would greatly increase accounting costs.

A second question asked in the SMACNA survey was the extent to which the firm would be negatively affected by the proposed change. Forty-two percent reported that they would be severely negatively affected.

Other ASC affiliated associations report similar proportions of their membership using completed contracts and similar negative effects. The question may be asked as to why 100 percent do not use it if it has such importance. There could be several reasons, but the foremost probably is that many specialty contractors do not perform enough long-term contracts to make it worthwhile to depart from accounting procedures used for other purposes. Contractors who are performing work that normally is completed within the tax year in which it is commenced or who have only a small percentage of their work carried over into other tax years have no need to use the completed contract method and do not have the severe cash flow problems generated by a long-term tie-up of working capital in retainages, equipment on the job site, materials stored for future use, and other such cash flow blocks associated with longer term contracts.

Although similar effects would be experienced by smaller companies on a level of fewer dollars but with, perhaps, a much greater impact, an example of what the loss of the completed contract method would do to a substantial specialty contractor fol-

lows. This contractor has used the completed contract method of accounting since the firm was founded in 1904 and consistently for income tax purposes since there has been a federal income tax. The company has an annual sales volume of approximately $200,000,000 and employs 2,800 craft employees and 1,200 engineers and administrative employees on approximately 400 open contracts. It does work in all areas of electrical construction with the exception of residential work, with an emphasis on powerplant construction and signal work for mass transit systems. The relative importance of its various markets and the average time span of contracts within each market are indicated below:

Percentage of contracts

Industry and duration estimate:	*Total*
Utilities (5 plus years)	55
Commercial, various (2 plus years average)	12
Transportation (3 years)	15
Engineering (Less than 1 year)	15
Miscellaneous (Less than 1 year)	3

The company has found that the full close-out of the contract generally occurs within twelve months after completion of on-site work, at a maximum. The maximum time delay, therefore, between physical completion of the work and tax reporting would be one tax reporting period.

The company calculated what the effect would be for the past nine years under the percentage of completion method of accounting compared with its present completed contracts method. It was determined that the taxable income for each year under the percentage of completion method would have been increased by the amount which represented the net effect of deferrals in that year under the completed contracts method. These increased tax payments then would require additional financing at the interest rates prevailing each year at tax time. The accumulated amount of borrowing that would have been needed for the nine-year period was $4,366,000 for taxes and $3,556,000 for interest on the funds borrowed for taxes. Assuming a deduction from taxable earnings of approximately 50 percent of the interest costs, the effect of the interest on net earnings and equity would have been $1,778,000. The total cash flow effect, therefore, was the $4,366,000 borrowed for taxes and $1,778,000 to cover the net interest payments, a total of $6,144,000. Since the company currently is entirely dependent upon its own earnings and borrowings for its working capital needs and does not pay any dividends, the prohibition of the completed contracts tax method obviously would have a significant impact on the internal financing of the company.

The need to borrow significant additional amounts would increase interest costs which would decrease the input to internal financing resources by reducing net income and, therefore, shareholders' equity. The company thus would have to borrow additional funds from outside sources to replace the $6,138,000. This presumes the availability of such funds for a company which, like most construction contractors, is heavily leveraged already. Historically the company has depended on a combination of debt, shareholder equity, as well as deferred taxes totaling some 17 percent of its revenues on an annual basis to produce cash flow working capital. The only way to make up the loss of the tax deferral and maintain that percentage is to go to the debt marketplace. However, the company presently has debt outstanding in the amount of $12,500,000, with a shareholders' equity in the amount of $13,240,000. A total debt of $18,638,000 would create an extreme situation. The debt to equity relationship would make it very difficult to obtain surety bonds in a marketplace where the size of contracts is increasing very rapidly.

A study of 13 large mechanical contractors' financial statements for the calendar year 1980 or for fiscal years ending in 1980 bears out the electrical contracting company's experiences and indicates the importance of deferred taxes in providing working capital until profits are actually realized on completed contracts. These 13 firms produced total sales of about $368 million with stockholders' equities of about $37 million. Deferred taxes of nearly $9 million equalled about six percent of total fixed assets and working capital in use.

FINANCIAL DATA OF 13 MECHANICAL CONSTRUCTION CONTRACTORS IN 1980

[In thousands]

Contractor	Sales	Deferred taxes	Total assets	Equity
1	$32,473	$398	$9,119	$3,918
2	25,935	75	14,725	3,717
3	18,191	829	7,692	1,949
4	20,901	845	8,339	3,008
5	10,276	301	4,025	1,158
6	12,025	562	6,197	1,702
7	37,543	2,105	16,251	4,694
8	37,994	77	9,645	3,067
9	75,150	1,751	35,036	6,418
10	17,813	650	4,288	2,208
11	17,727	760	6,288	1,732
12	26,038	39	7,220	2,818
13	35,743	337	10,331	1,700
Total	367,809	8,726	139,096	37,089

It should be noted that the Treasury Department's proposal for the optional progress payment method would put each contract, and, in fact, some individual change orders, on a separate basis, which could then require the contractor to pay the tax on the illusory amounts by which revenues may have exceeded costs on one contract in one year, even though costs might have exceeded revenues substantially on all the other contracts performed that year. Unable to recover or offset losses until these losing contracts were completed but taxed on excess revenues on contracts which appear profitable, the contractor would be advancing money to the Federal Government at no interest.

It is clear that the impacts of disallowing the completed contracts method of tax accounting on construction contractors of many different sizes and specialties would include a substantial increase in the rate of contractor failures, increased construction costs, decreased completion and decreased productivity. There is no reason to believe it would result in any increased revenues to the Federal Government. It is the timing of the payments rather than the amount of payments that would be affected by the proposed change in accounting procedure. Reduction of the tax base and increase in interest deductions would probably reduce tax revenues from the construction industry over a period of time.

We are not attempting to pass judgment on the propriety of permitting completed contracts accounting for manufacturing industries, which was not permitted until 1976. Most of the Treasury Department's reasons for their proposals appear to apply to long-term manufacturing contracts rather than to the types of contracts which are called long-term contracts in the construction industry but which are completed much sooner than many defense manufacturing contracts. The construction industry has used the completed contracts method since 1918, and the Treasury Department and Internal Revenue Service have acknowledged the peculiarities of the construction industry which have justified this method.

Chairman ROSTENKOWSKI. Mr. Carter, you may proceed.

STATEMENT OF BILLY R. CARTER (VICE PRESIDENT, FINANCE, NELLO L. TEER CO., DURHAM, N.C.), CHAIRMAN, TAX AND FISCAL AFFAIRS COMMITTEE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. CARTER. Thank you, Mr. Chairman.

I am the vice president of finance of Nello L. Teer Co. of Durham, N.C.

I am appearing today for the Associated General Contractors of America as chairman of the association's tax and fiscal affairs committee.

Accompanying me today is Mr. John Sroka of the AGC staff.

I will summarize the written statement that has already been submitted.

I am testifying on a proposed revision to the completed contract method of accounting. I want to emphasize from the beginning that the use of the completed contract method in construction is different from the way it is used in other industries. The reasons for change outlined in the Treasury Department's explanation do not apply to the construction industry.

By eliminating completed contract accounting and two other standard income tax accounting methods, cash and accrual, and substituting an entirely new concept of taxing cash flow instead of profits, the Treasury will severely injure construction in attempting to correct problems apparently found only in other industries.

Completed contract accounting was recognized as the appropriate accounting method for construction in Treasury regulations dating back to 1918 due to the unique nature and inherent risk in construction. Those risks are just as great and the unique nature of construction is as meaningful today as they were some 64 years ago.

In 1976, after 5 years of public debate, regulations were issued relating to long-term contract accounting, not to correct contract abuses, but to codify case law and existing practice and to extend long-term construction accounting to manufacturing and other industries.

The reasons for change listed in the Treasury description of its initiative on long-term accounting methods indicates that all distortions of income reporting occur as a result of exceptional duration contracts, 10 to 20 years, which are virtually nonexistent in the construction industry.

Currently the construction industry uses the cash, accrual, percentage of completion, and completed contract methods. The most important method is completed contracts.

However, cash and accrual accounting are used mainly by small firms, especially those firms entering the construction industry for the first time, because the ease of application outweighs the cost of the early tax payments that they produce.

These companies operate in the form of proprietorships, partnerships, subchapter S corporations, as well as regular corporations.

They keep their records on either a cash or an accrual basis for both financial and tax reporting.

As they grow and gain business experience, cash or accrual accounting is generally replaced by the completed contract method because of the better determination of income.

The diversified nature of the construction industry requires this accounting flexibility. Eliminating cash and accrual in addition to the completed contract option from use by construction is arbitrary and punitive, since cash and accrual will still be available for other taxpayers and completed contract method best reflects income from construction.

The progress payment method is an entirely new concept, not based on any known theory of income taxation. Under the progress payment method all contracts currently showing a positive cash flow, payments in excess of expenditures, would be subject to income taxation on that positive cash flow.

However, negative cash flow contracts would not be allowed to offset this tax liability.

Far more important, however, is the fact that contractual liabilities are ignored in determining income. Cash flow has no relation to profit for income tax purposes. Interim progress payments do not necessarily contain any element of profit, nor do they directly relate to the cost of the work performed because of various cash flow management practices in the construction industry.

Whatever payments a contractor may receive during the construction process are subject to his contractual liability to perform the work of the contract. No traditional theory of income taxation would require the income determination before all events have occurred which fix the right to receive such income. This is a fatal flaw of the proposed progress payment method of accounting which we believe to be insurmountable as far as construction is concerned.

The completed contract method is the dominant tax reporting method in construction because it is fair, equitable, and most importantly accurate.

Contract costs and profits are determined when a project is complete and accepted. No gain or loss is recognized for income tax purposes until contract completion.

We believe that the completed contract method properly reflects construction contract income and must be preserved as far as it applies to the construction industry.

Included in the Treasury Department's proposal are a variety of changes to the regulations relating to the completed contract accounting. Some of these regulatory changes are designed to implement the legislative proposal while others would drastically confuse the administration of the completed contract accounting independent of any legislative changes.

The current rules are based on 60 percent of experience developed in the Treasury and the Internal Revenue Service. Without any significant reason for change, the Treasury has proposed a wholesale revision of these rules.

The principal changes are found in the allocation of indirect costs. There are 27 categories of indirect costs listed in the regulations. Fourteen of these cost factors are allocated to contracts, and deducted at the contract completion. Thirteen cost factors are deducted currently as a reflection of current business operating expenses which are not appropriately allocable to any contract.

The current regulations dealing with period cost deductions were issued in 1976 and reflect a 5-year dialog between Treasury and industry regarding a determination of appropriate and valid allocable costs and current costs. The validity and appropriateness of these period costs have not changed in the 5 years since their enactment, and should not now be revised.

I would like to reiterate that the reasons for change identified by the Treasury in its general and technical explanation apply to contracts of extended duration.

We believe that certain changes to the regulations can be made to correct these problems without affecting the historic and traditional applications of the existing accounting methods as they apply to construction.

These changes do not require new legislation. In addition to my testimony, I would like to submit a technical analysis of the issue for the record which we have already made available to Treasury.

[The prepared statement follows:]

STATEMENT OF BILLY R. CARTER FOR THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. Chairman and members of the committee, good morning, my name is Billy R. Carter. I am the Vice President of Finance of Nello L. Teer Company in Durham, North Carolina. I am testifying for the Associated General Contractors of America as Chairman of the Association's Tax and Fiscal Affairs Committee. Accompanying me today is Hubert Beatty, the Executive Vice President of the Associated General Contractors.

The Associated General Contractors of America (AGC) represents more than 30,000 firms, including 8,500 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 employees. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities.

I am testifying today on a tax revision included in the Administration's proposed 1983 budget dealing with the completed contract method of accounting. I want to emphasize from the beginning that the use of the completed contract method in construction is different from other industries which use the method. The industry is deeply concerned about this proposal because the reasons for change in the Treasury Department explanation do not apply to the construction industry's use of the method. By eliminating this accounting method and two other standard income tax reporting methods—cash an accrual—the Treasury will severely injure the construction industry in attempting to correct problems found in other industries.

I would first like to give you a brief glimpse of the construction industry and the importance of the completed contract method of accounting to the industry.

The method was recognized as the appropriate accounting method for construction in Treasury regulations dating back to 1918 due to the unique nature and inherent risks in construction. Those inherent risks and the unique nature of construction are as great and as meaningful today as they were some 64 years ago.

They include differing site and soil conditions; climate conditions; firm prices for the duration of the contract which require the contractor to bind himself to an unalterable price before actual costs are known; owner retention policies; changes; modifications or claims during the course of the contract which require the contractor to expend large sums in advance of his contractual right to collect from the owner; and intense competition within the industry which forces profit margins to be exceedingly small in relation to the total gross contract amount; among many others.

The unique nature and inherent risks of construction necessitate that profit, if any, will be known only after completion of the project when the owner has accepted it and all retention has been returned through every level of the general contracting and subcontracting process, and even then only if all claims and disputes have been settled.

The reasons for change listed in the Treasury description of its initiative on long-term accounting methods do not include any significant problems found in the application of the completed contract method of accounting in the construction industry. All distortions of income reporting, including any in indirect cost period deductions, occur as a result of exceptional duration contracts (10–20 years) which are non-existent in the construction industry.

It is not surprising that the reasons for change are silent as they apply to the construction industry, since distortions in the use of the completed contract method are not evident in the construction industry.

Virtually all construction contracts have retainage provisions. In some instances the retainage arises through a contractual provision for progress billing; in others there is a specific retainage of a percentage of the portion of the contract price applicable to work completed to date. The amount of the retainage is ordinarily a very large part of the profit to be realized, and in most cases is equal to or exceeds the total estimated profit from the contract. Retainages are also often used for correction of defects after project completion. In all cases, retainage is not released to the contractor until after project completion. Consequently, the profit element of a construction contract is not received until retainage is released.

For the past 64 years, the completed contract method has properly required a construction contractor to wait until contract completion and acceptance before deter-

mining income tax liability, thus enabling full use of interim payments. These payments may be used in any business function and make up a significant portion of working capital the most significant fiscal category in construction unlike many other industries.

The industry has literally matured and grown in reliance on the completed contract method and the resultant use of working capital. Working capital represents liquid assets which a contractor uses to run his business. If sufficient liquid assets are not available, the contractor must either default or borrow, if able, against the value of other assets to attempt to continue ongoing operations.

The construction industry is a contradiction of the "greater the risk, greater the return" theory. For example, general contractors in the commercial sector can expect little more than a one percent return on their operating revenues. Considering this meager return, most companies do not have access to the capital markets as a means of increasing their equity and, in fact, have great difficulty in obtaining loans to satisfy their cash requirements.

The vast majority of construction companies operate in a high risk, low return environment; they are by most standards greatly under capitalized and maintaining a survival rate of cash flow is an everyday way of life.

To discard the completed contract, accrual and cash methods as acceptable alternatives for income tax reporting would cause further severe cash shortages in an industry already beset with a lack of adequate cash reserves. Currently the construction industry uses the cash, accrual, percentage of completion and completed contract methods. The most important method is completed contracts. However, cash and accrual accounting are used by small firms, especially those firms entering the construction industry for the first time because their ease of administration outweighs the higher tax liability they produce. These companies do business in the form of proprietorships, partnerships, Subchapter S corporations, as well as regular corporations. They keep their records on either a cash or accrual basis for both financial and tax reporting. As they progress as business entities cash or accrual accounting is generally replaced by the completed contract method because of technical problems with cash and accrual which distort income as their business functions expand. The diversified nature of the construction industry requires this accounting flexibility. Eliminating cash and accrual, in addition to the completed contract option, from use by construction is arbitrary and punitive since cash and accrual will be available for other taxpayers. The resultant effects would be massive defaults of contractors and subcontractors and a contraction of industry production. The ripple effect of this contraction on service and material suppliers to the construction industry would be staggering.

As I will explain shortly, the Treasury Department's proposal will have a severely detrimental effect on the construction industry due to the sweeping revisions of traditional income tax reporting methods it purports to make. Of the industries currently reporting income tax from long-term contracts, the construction industry will be the most severely impacted because it is made up of thousands of small firms. These small firms will find it extraordinarily difficult to administer the two tax accounting methods the Treasury proposes to require taxpayers to use if they have income from long-term contracts. One of these methods—the progress payment method—is an entirely new accounting method which fails to conform to any traditional theories of income taxation.

The Treasury Department's proposal is particularly unacceptable to the construction industry because regulations administering our tax reporting methods were thoroughly revised in 1976. At that time the Treasury had 58 years of experience in administering construction income tax reporting. We can find no significant reason for changing our tax reporting methods in the Treasury Department's explanation. The reasons for change described by Treasury all focus on extended duration contracts reporting under the completed contract method of accounting. Extended duration contracts were not a significant problem in completed contract method reporting regulations until 1976 when the regulations were revised. Income distortions found in those new industry users of the method can be corrected without affecting the construction industry and without any new legislation.

LEGISLATIVE PROPOSAL

The Treasury Department's proposal would eliminate three of the four methods of reporting construction contract income. The most important method is completed contracts.

Under the Treasury proposal construction firms would be allowed to use the percentage of completion method or a new progress payment method of accounting.

The percentage of completion method is by far the most complicated system now available, and due to a variety of technical problems and the inability to accurately estimate income it is not widely used. The progress payment method is an entirely new concept, not based on any known theory of income taxation. Under the progress payment method all contracts currently showing a positive cash flow (payments in excess of expenditures) would be subject to income taxation of that positive cash flow. However, negative cash flow contracts would not offset this tax liability.

Far more important, however, is the fact that contract liabilities would be ignored in determining income. Cash flow has no relation to "profit" for income tax purposes. Interim progress payments do not contain any element of profit, and they do not directly relate to the cost of the work performed because of various cash flow management practices in the construction industry. Whatever payments a contractor may receive during a construction project are subject to his contractual liability to perform the work of the contract. No traditional theory of income taxation would allow a tax liability to be determined without reference to liabilities. This is a fatal flaw of the proposed progress payment method of accounting which we believe to be insurmountable.

The completed contract method is the dominant tax reporting method in construction because it is fair, equitable and most importantly, accurate. Contract costs and profit are determined when a project is completed and accepted. No gain or loss is recognized for income tax purposes until contract completion and acceptance. The method precedes the income tax as the appropriate financial accounting method for construction projects. Its use for income tax reporting was recognized first in Treasury Department regulations published in 1918 pursuant to the 1916–17 Revenue Acts. As I mentioned earlier, the completed contract regulations were fully revised in 1976 after several sets of proposed regulations were published and commented on by the industry from 1971–76. We believe that the regulations properly reflect construction contract income and that the regulations, as well as the completed contract method of accounting, must be preserved so far as they apply to the construction industry.

REGULATORY PROPOSAL

Included in the Treasury Department's proposal are a variety of changes to the regulations implementing the completed contract method of accounting. Some of these regulatory changes are designed to implement the legislative proposal while others would drastically confuse the administration of the completed contract method of accounting, independent of any legislative changes.

The completed contract method of accounting was subject to a major regulatory revision in 1976. The regulations were published after a five-year comment period on several proposed regulations starting in 1971. The rules worked out in implementing the completed contract method of accounting as it applies to the comstruction industry were based on 58 years of experience developed in the Treasury and IRS. Without any significant reason for change, the Treasury has proposed a wholesale revision of the technical rules for administering the completed contract method of accounting.

The principal changes as they affect construction are found in the allocation of indirect costs. There are 27 categories of indirect costs. Under current regulations 14 are allocated to the contract (deducted at contract completion). Thirteen cost factors are deducted currently as a reflection of current business operation expenses which are not appropriately allocable to any contract. The existing period cost deductions reflect a five-year dialogue between Treasury and industry regarding a determination of appropriate and valid allocable costs and current costs. The validity and appropriateness of these period costs have not changed in the six short years since their enactment, and should not now be revised.

I would like to reiterate that the reasons for change identified by the Treasury in its General and Technical explanation apply to contracts of extended duration. We believe that certain changes to the regulations can be made without affecting the historic and traditional application of the method as it applies to construction. These changes do not require new legislation or modification of the method as it applies to construction.

In addition tc my testimony, I would like to submit a full technical analysis of the issue for the record which we have already given to the Treasury Department.

Thank you.

[Attachment]

COMMENTS ON FEBRUARY 26, 1982, DEPARTMENT OF TREASURY GENERAL/TECHNICAL EXPLANATION REGARDING THE COMPLETED CONTRACT METHOD OF ACCOUNTING

GENERAL COMMENTS

The completed contract method of accounting requires a taxpayer to wait until the contract is completed and accepted before reporting income (gain or loss) from the contract. The accounting method is a traditional construction accounting technique which preceded the U.S. income tax. Its use was recognized for income tax purposes in regulations published in 1918 which implemented the 1916–17 Revenue Acts. It was recognized as the appropriate accounting method for construction due to the unique nature and inherent risks in construction. Those inherent risks and the unique nature are as great and as meaningful today as they were some 60 years ago.

They include differing site, not owned or controlled by the contractor, varying soil conditions and climate conditions; firm prices for the duration of the contract which require the contractor to bind himself to an unalterable price before actual costs are known; owner retention policies; changes; modifications or claims during the course of the contract which require the contractor to expend large sums in advance of his contractual right to collect from the owner; and intense competition within the industry which forces profit margins to be exceedingly small in relation to the total gross contract amount; among many others.

This unique nature and the inherent risks necessitate that profit, if any, will be known only after completion of the project when the owner has accepted it and all retention has been returned through every level of the general contracting and subcontracting process, and even then only if all claims and disputes have been settled.

The reasons for change listed in the Treasury description of its initiative on long-term accounting methods do not include any significant problems found in the application of the completed contract method of accounting in the construction industry. All distortions of income reporting, including any in indirect cost period deductions, occur as a result of exceptional duration contracts (10–20 years) which are non-existent in the construction industry.

It is not surprising that the reasons for change are silent as they apply to the construction industry, since distortions in the use of the completed contract method are not evident in the construction industry. The distortions that are evident by other users of the method could be limited by simply modifying Section 1.451(e)(i) to provide a basis for severing long-term production contracts by units of delivery and acceptance or some other similar arrangement, without concommitantly penalizing the construction industry's use of the method.

SPECIFIC COMMENTS ON TREASURY DEPARTMENT GENERAL/TECHNICAL EXPLANATION PROGRESS PAYMENT METHOD

1. The proposal in noting "that taxpayers must elect to use either the percentage of completion method or the progress payment method of accounting for long-term contracts" eliminates not only the completed contract method but the cash and accrual methods as well. Since many construction companies take the form of proprietorships, partnerships, Subchapter S Corporations as well as regular corporations, many construction companies keep their books on one of these two methods for both financial and tax reporting. Eliminating these two options, in addition to the completed contract option, from use by construction companies would be arbitrary, capricious and punitive, particularly since cash and accrual will still be available for other taxpayers. Additionally, since the cash and accrual methods tend to cause income to be reported earlier than either the percentage of completion or the completed contract method, the proposal would actually result in a reduction of tax revenues.

2. The proposed progress payment method deviates from all traditional theories of business entity taxation, i.e. taxation of profits, by imposing a tax on positive cash flow independent of any reference to concurrent liabilities.

3. The proposed progress payment method would result in the taxing of receipts when, in fact, no income had actually been earned. It would also not permit the offset of losses calculated on the same basis, thus requiring that each contract be treated as a separate and complete "company" with no consolidation for income tax purposes. A medium sized general contractor might have between 20 and 40 open contracts in progress at any one time. To require the payment of taxes on contracts with positive cash flow while disallowing a reduction in taxes for contracts with

negative cash flow would cause a cash drain that would be certain financial death. In the construction industry, each contracting company is operated as a whole, not on a project-by-project basis.

4. The proposal is based on a misunderstanding of the construction industry's operating method. Interim progress payments do not contain any element of profit, and they do not directly relate to the cost of the work performed because of various cash flow management practices in the construction industry notably; mobilization payments, contract advances, and higher monetary value of work performed in the early stages of a construction project.

(a) Mobilization advances represent a recognition by the onwer that there are capital costs in the early phases of a construction project that cause a heavy strain on a contractor's financial structure. Generally, the amount of the mobilization advance is determined during the bidding process by taking value from certain activities and adding the value to the mobilization pay item. To tax the mobilization payment as income overlooks the fact that the contractor must still perform the work before he has earned any profit. The depreciation or amortization of capital or life of contract expenditures, like bond premiums, can only be charged to cost over a period of time or the life of the project. Some contracts that have mobilization advances are, in fact, completed at a loss for the overall contract. The proposal could result in a contractor being required to pay a tax on mobilization advance on a project that ultimately shows no profit and not being able to recover the tax payment for two or three years.

(b) Contract advances are a recognition by the onwer of the cost of acquiring large amounts of construction equipment and, on foreign projects, of the cost of shipping it to a foreign country and the risk of making large investments in countries that may have unstable governments. These advances are nothing more or less than secured loans. They are secured by irrevocable letters of credit (some of which may require compensating deposits of a part of the contract advance), bank guarantees or surety bonds and must be repaid over the life of the project by prorated deductions from progress billings. Taxing contract advances is tantamount to taxing working capital loans.

(c) Unbalanced bidding and front-end loading are two cash flow management practices which place a higher monetary value on work performed in the early stages of a construction project with a concommitant reduction in the monetary value of work performed in later stages of the project. These cash flow management practices are used to insure recovery of fixed costs and reduce the amount of outside financing necessary for the project thus reducing the overall price for the project. It must be emphasized again, however, that improved cash flows are not profits and do not directly relate to the cost of the work performed.

The treatment of such payments is inadequate in the technical explanation. Such payments are the rule and not the exception in the construction industry, and will result in an inundation of requests for extended prorated periods for treatment of such payments. In addition, these payments are used for purposes which do not result in offsetting tax deductions due to the type of expense for which the case is used, e.g. collateral for lines of credit, equipment depreciation over periods longer than a year. As a result, basing tax liability on temporary positive cash flow created by these payments, reduced only by current deductible liabilities, would grossly distort income.

5. Further evidence that progress billiings do not represent earnings is the concept in accounting literature of treating progress billings in relation to cost and earnings. Under Generally Accepted Accounting Principles (GAAP) when utilizing the percentage of completion method, progress billings in excess of cost and earnings (determined by applying one of the accepted earnings' calculations) must be reflected in the balance sheet as a liability and where cost and earnings are in excess of billings, they must be reflected in the balance sheet as an asset. The proposal would tax the liability (excess billings) but would not allow an offset of the asset (excess costs).

6. The proposal states that the new provisions intend to reduce "the tax advantages available to taxpayers who are able to use the completed contract method." The apparent intent of the provision is to place contractors on the same basis as a manufacturer reporting taxes currently. Yet the proposal states that if a contractor begins two contracts during a year, one showing a profit and one showing a loss, using the "Progress Payments Method" there would be no offsetting of profit and loss on the two contracts. The manufacturer is allowed to offset gains and losses on the sale of his units and in fact will often use "loss leaders" to encourage sales. Furthermore, the manufacturer is not forced to allocate all overhead expenses to inventory since present regulations allow for a practical capacity level for purposes of allocation recognizing that not all indirect costs are allocable. Manufacturers are fur-

ther allowed to elect LIFO as a method of valuing their inventory which allows them a permanent deferral as compared to a deferral under the completed contract method. A manufacturer can alternatively elect to value inventory at the lower of cost or market which allows a write-off of expense even before a sale is made and realization of the loss.

PERIOD COST DEDUCTIONS

7. A wholesale revision of the period cost deductions is not necessary or warranted. Providing contract segregating rules for extended duration manufacturing and other production type contracts which construction is not, would drastically lessen the inflation effect of current period deductions. For example, the inflation effect of currently (1982) deductible pension and profit sharing plan contributions are significantly higher in economic value when the income being reported is from a 1970 contract rather than a 1980 contract.

The present period cost deductions were developed between 1971 and 1976 when the IRS issued three sets of proposed regulations. The final regulations were published after strong industry protest to earlier regulations which attempted to require conformity between financial and tax accounting. The existing period cost deductions reflect a five year dialogue between Treasury and industry regarding a determination of appropriate and valid allocable costs and current costs. The validity and appropriateness of these period costs have not changed in the five short years since their enactment, and should not now be revised.

Revision of the period costs as proposed in the technical explanation would not reflect the realities of the construction industry. Examples include:

(a) Interest allocation to contracts is often impossible to determine due to the general practice of borrowing money for general working capital purposes for a number of open contracts. These loans would be difficult to trace to individual contracts in exact proportions due to the variety of billing and advance payment practices in the industry. Interest allocation as a result of equipment purchases would similarly be impossible, since a piece of equipment could be used on 20, 30, or any number of contracts during a year. In addition, interest income is not allocated to long-term contracts. Requiring interest expense allocations for deferral recognition would, in our view, also require allocation.

(b) The proposal determines that all general and administrative expenses can be allocated, which is unrealistic. One general guideline in the past for distinguishing between job costs and period cost is that costs allocable to the contract must be incurred "incident to and necessary" for the performance of the long-term contract. This phrase is taken from the regulations undcer Section 471 relating to inventory costing. Under such regulations a production cost must be incurred incident to an necessary for production in order to be considered an inventoriable cost. The proposal appears to have singled out the construction industry and stated that other than the list suggested all other general and administrative expenses are incident to and necessary to specific contracts, when in fact these expenses are impossible to ratioanlly allocate to any given contract. For example, janitorial expenses are not a cost which can be allocated to a contract in any administrable manner since it is a necessary cost for all business operations. Certain compensation, legal and accounting expenses, public relations, among many others, present similar problems.

(c) Under the proposal accelerated depreciation would be an allocated cost attributable to a particular long-term contract. While the Treasury Department may feel that this expense can be properly allocated to a particular job, which is a dramatic change from existing tax law, such allocation is virtually impossible. A large contractor may have a fleet consisting of thousands of individual pieces of equipment many of which may work on many different jobs during a year. Many contractors allocate equipment by the use of a pool of equipment concept where all equipment costs are accumulated and then billed to individual jobs at a rate sufficient to recover the cost of each piece of equipment on a straightline basis over its estimated hours of production. The rate used for charging equipment to jobs based on the hours of use on the particular project has depreciation expense computed on a straightline basis. The net result of unallocated equipment expense not charged to jobs will be the result of accelerated depreciation and idle time on equipment during the year as currently allowed by regulations. The allocation of expense to jobs is always at best an estimate and never an exact method.

(d) The proposal would also require the allocation of pension and profit sharing expenses representing current service costs as allocable to specific construction contracts. An employee may work on many different contracts during a particular year

and in the case of a profit sharing contribution the actual amount credited to an employee may not be determined until long after a year ends. An allocation to specific jobs on any type of current basis would be virtually impossible. Furthermore, an employee may be only partially vested in his pension and profit sharing account and if he left the employ of the company would forfeit part of his allocation. Does the Treasury envision an adjustment to closed jobs in future years for forfeitures lost by an employee reallocated to current employees working on current jobs? As can be seen the burden of accomplishing the allocation would be impossible.

IMPACT OF PROPOSED CHANGES ON THE CONSTRUCTION INDUSTRY

Construction variables not found in other industry users of the completed contract method include working on different sites which are not controlled by the contractor for each project; variable weather and soil conditions for each construction project; a diversified labor structure which must be coordinated; payment retentions by an owner; changes, modifications, or claims during the contract term which require the expenditure of large sums by the contractor before the contractual right to collect from the owner; intense competition in the industry which creates extremely narrow profit margins in relation to gross contract amounts. These variables necessitate that profit on a construction contract is not known until contract completion and acceptance.

Large sums must be expended by a contractor in advance of his contractual right to collect from his client. Because of the large total contract sums involved, this stretches the financing capacity of construction contractors on a regular basis.

Virtually all construction contracts have retainage provisions. In some instances the retainage arises through a contractual provision for progress billing; in others there is a specific retainage of a percentage of the portion of the contract price applicable to work completed to date. The amount of the retainage is ordinarily a very large part of the profit to be realized, and in most cases is equal to or exceeds the total estimated profit from the contract. Retainages are also often used for correction of defects after project completion. In all cases, retainage is not released to the contractor until after project completion. Consequently, the profit element of a construction contract is not received until retainage is released.

For the past 60 years, the completed contract method has properly allowed a construction contractor to wait until contract completion and acceptance before determining income tax liability, thus enabling full use of interim payments. These payments may be used in any business function and make up a significant portion of working capital, the most significant fiscal category in construction unlike many other industries.

The industry has literally matured and grown in reliance on the completed contract method and the resultant use of working capital. Working capital represents liquid assets which a contractor uses to run his business. If sufficient liquid assets are not available, the contractor must either default or borrow, if able, against the value of other assets to attempt to continue ongoing operations.

The construction industry is a contradiction of the "greater the risk, greater the return" theory. For example, general contractors in the commercial sector can expect little more than a one percent return on their operating revenues. Considering this meager return, most companies do not have access to the capital markets as a means of increasing their equity and, in fact, have great difficulty in obtaining loans to satisfy their cash requirements.

The vast majority of construction companies operate in a high risk, low return environment; they are by most standards greatly under capitalized and maintaining a survival rate of cash flow is an everyday way of life.

To discard the completed contract, accrual and cash methods as acceptable alternatives for income tax reporting would cause further severe cash shortages in an industry already beset with a lack of adequate cash reserves. The resultant effects would be massive defaults of contractors and subcontractors and a contraction of industry production. The ripple effect of this contraction on service and material suppliers to the construction industry would be staggering.

The following actual cases and examples will serve to illustrate some of the effects on the industry: Company A is a small general contractor with operating revenues of approximately $4 million in 1979, which increased to approximately $8 million in 1981. Its condensed balance sheet at December 31, 1979 is as follows:

Condensed balance sheet, company A, Dec. 31, 1979

Current assets	$870,000
Other assets	61,000
Total assets	931,000
Current liabilities	700,000
Shareholders' equity	231,000
Total liabilities and equity	931,000

At December 31, 1979, the company had a contract which was 40 percent complete and had received payments in excess of contract costs of $245,000, which under the progress payment method would have resulted in taxes payable of approximately $112,000. During calendar year 1980, the contractor encountered severe problems with the project which resulted in projected significant losses in 1980 and 1981, culminating in a total loss of $940,000 at December 31, 1981. Also during 1980 the contractor began work on additional projects and at December 31, 1980, the condensed balance sheet is as follows:

Condensed balance sheet, company A, Dec. 31, 1980

Current assets	$1,400,000
Other assets	1,000
Total assets	1,401,000
Current liabilities	1,274,000
Shareholders' equity	127,000
Total liabilities and equity	1,401,000

At December 31, 1980, the company had other projects on which payments in excess of cost equaled $575,000 which under the progress payment method would have resulted in an additional tax payable of approximately $265,000.

Under the proposed progress payments method, the contractor would have paid taxes as follows:

Dec. 31, 1979	$112,000
Dec. 31, 1980	265,000
Total	377,000

At this point in time, the contractor cannot pay the income taxes out of the company's working capital, which is now negative, and cannot get a loan based on the financial statements of the company. The company is, in fact, probably out of business.

Fortunately, the completed contract method more accurately reflected the results of all contracts, and the company paid no taxes in 1979 and 1980. The company was able to survive and during calendar year 1981 had operating revenues of approximately $8 million on which it was able to derive acceptable profits.

Company B has a deferred tax liability of $5 million of which under the completed contract method $2.5 million is payable at the end of its current fiscal year. Company B also has a net worth of $6 million and working capital of $8 million. A bonding company considers net worth and working capital in determining the amount of work in progress it will permit Company B. The bonding company also considers deferred taxes not to be paid in the current year as a reduction in current liabilities, thereby increasing working capital.

In this instance, $2.5 million not due in the current year in deducted from current liabilities, increasing working capital by $2.5 million, from $8 million to $10.5 million. The bonding company will allow $20 of work in progress for each dollar of working capital. Under these circumstances, the bonding company will permit work in process of $210 million ($10.5 million times 20); however, if under the percentage of completion or the progress payment method, Company B must pay an additional $2.5 million in income taxes, then the bonding company will in this case reduce the amount of work in process allowed approximately $50 million ($2.5 million times 20) or from $210 million to $160 million.

In a work program consisting of $210 million, work in progress, total operating revenue for a fiscal year would be in the range of $150 million and if the general contractor is doing 40 percent of the work with his own forces, the contractor would be employing approximately 800 employees. If the contractor's volume is thus reduced approximately 25 percent ($50 million divided by 210), then 200 of his 800 em-

ployees would become unemployed. Likewise, the approximately 1,200 subcontract employees would be reduced by 300 employees.

The reduction in the work force of the general contractor and of the subcontractor does not take into account the ripple effect on the hundreds of material and service supplies to the general contractor and the subcontractors.

In addition, the proposals would not be without an immense administration burden. The proposed progress payment method would necessitate the creation of a whole new set of books for tax purposes.

At the present time a conversion to the completed contract method can be accomplished simply by the reporting of completed contracts and the continued accumulation of jobs of progress. The conversion of all contracts to the "progress payment method" for revenues and the proposed allocation of expenses would be an unrealistic burden. In addition to the burden of establishing the new method of reporting, the audit of returns by the Internal Revenue Service under the progress payments method would be almost impossible. Actual experience an examination under the completed contract method of accounting substantiaties he problems that IRS auditors would have using hindsight in the audit of returns under the "progress payment method." Most auditors would not have time to verify the adjustments to revenue and expenses on each contract nor realistically be in a position to question the proposed arbitrary allocations. Upon audit, persuading the IRS agent that a correct method of allocations was used would open a whole new area of investigations and litigation. Currently, the IRS regulations are clear on what indirect costs would be allocated and those that are not required to be included in costs attributable to a long-term contract. In addition to the problem of a method of allocating indirect, costs, there exists the problem of accounting for such an allocation. Financial accounting methods impose the requirement that indirect costs cannot be allocated to the cost of a contract.

Indirect costs are considered period costs and should be deducted currently. The proposed amendments would require the maintenance of separate sets of books to allocate these indirect costs to long term contracts. Many small and medium sized contractors and subcontractors simply do not have the administrative staff or professional acountants to keep track of all these allocations. The mere cost of record keeping and compliance could cause them to go out of business.

SUMMARY

1. There are no valid reasons for limiting the use and/or availability of the completed contract method of accounting in the construction industry. Distortions in the use of the completed contract method are not evident in the construction industry. The distortions that are evident by other users of the method could be limited by simply modifying Section 1.451-3(e)(i) to provide a basis for severing long-term production contracts by units of delivery and acceptance or some similar arrangement.

2. Application of the proposed changes to the construction industry would severely penalized the industry for other users distortions of the completed contract method. Restricting working capital in the construction industry by imposing a tax on interim contract proceeds, which will occur under any method other than the completed contract method, will result in defaults, reduction in the scope of a contractor's business operations, and forcing the industry as a whole to seek more outside financing for its projects, an action that may not be economically feasible in the current economic climate.

3. There must be no change in the availability or use of the completed contract method in the construction industry.

Chairman ROSTENKOWSKI. Thank you, Mr. Carter.

Mr. Conable will inquire.

Mr. CONABLE. I have no questions.

I must say you gentlemen react vigorously to the proposal. It is obvious that it is a matter of considerable concern to you. There is nothing wrong with your coming in and expressing those concerns. We appreciate it.

Chairman ROSTENKOWSKI. Mr. Fowler will inquire.

Mr. FOWLER. I have no questions.

Chairman ROSTENKOWSKI. Thank you for joining us this morning.

Mr. Froehlke, if you would like to identify yourself and your associates for the record, you may proceed.

STATEMENT OF ROBERT F. FROEHLKE, PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE, ACCOMPANIED BY ROBERT EWING, CHAIRMAN OF THE BOARD AND PRESIDENT, BANKERS LIFE & CASUALTY CO., CHICAGO, ILL., AND RICHARD V. MINCK, EXECUTIVE VICE PRESIDENT FOR GOVERNMENT RELATIONS

Mr. FROEHLKE. Good morning, Mr. Chairman.

I am Bob Froehlke, president of the American Council of Life Insurance. On my right is Bob Ewing, chairman and president of the Bankers Life & Casualty Co. of Chicago, Ill. And on my left is Dick Minck, the executive vice president in charge of government relations for the American Council.

I appreciate having this opportunity to discuss with you gentlemen the administration's revenue proposals. I have a complete statement which I have submitted. I ask that it be made a part of the record.

Chairman ROSTENKOWSKI. If you would care to summarize, your entire statement will be included in the record.

Mr. FROEHLKE. Thank you.

The American Council of Life Insurance is a trade association made up of 524 life insurance companies. These 524 life insurance companies write 96 percent of the life insurance in force in the United States, have 97 percent of the life insurance assets, and 99 percent of the pension life insurance assets.

As you know, life insurance is taxed under the 1959 Life Insurance Company Income Tax Act. During the 1960's this act worked reasonably well. However, in the period of the decade of the 1970's, with the advent of inflation, some very apparent flaws did come about.

I believe anyone who has looked at this act now recognizes that the act should be revised.

The American Council of Life Insurance, however, has reluctantly concluded that because of practical political considerations, this act cannot be revised in its entirety this year. It is a very complicated Act, a very technical act.

We have, therefore, developed stopgap legislation; legislation, incidently, that all of the life insurance industry does support.

The purpose of this stopgap legislation is twofold. On the one hand, it will increase revenue to the Government, and on the other it will allow time for the Congress to completely revise the 1959 act.

The American Council of Life Insurance endorses H.R. 6045, which was introduced into the House yesterday, cosponsored by Congressman Holland, Congressman Frenzel, and Congressman Conable, and numerous other members of this committee.

The American Council of Life Insurance is united behind H.R. 6045. It will temporarily set tax rules under which the life companies will pay a reasonable level of taxes, and will allow time for this committee to come up with a complete revision of the 1959 act.

My statement spells out in detail the provisions of the proposal. Let me briefly touch on them.

You are aware that the Secretary of the Treasury recommended abolishing section 820 of the code dealing with the taxation of life insurance companies. His recommendation, if followed, would bring

in revenue to the Government of an additional amount estimated by Treasury to be slightly less than $2 billion per year. Our stopgap proposal would increase the revenue to the Government by $1 billion more than current law.

We recognize that section 820, the so-called ModCo provision, has been used to an extent that wasn't originally intended, and should be changed. We recommended in our stopgap a change in section 820. But everyone who has studied the 1959 code has agreed that there is more wrong with that code than just section 820.

We think you should take a look at H.R. 6045. There are a number of other recommendations included in the stopgap proposal. Nevertheless, H.R. 6045 remains a relatively simple legislative proposal.

The key question, I suppose, is, Is the life industry taxed too much or too little? It is difficult to answer that question, and in answering it unfortunately I believe we must deal with some statistics.

Between 1960 and 1978, the life insurance companies taxes increased six times. At the same time, their operating gain increased four times. All other corporate taxes increased three times, while their operating gain increased 4½ times.

Permanent life insurance reserves went up 2½ times, and nonpension assets went up two times.

We believe these statistics do indicate that the law of 1959 was becoming confiscatory in the period through 1979.

Life insurance companies must remain competitive. If we pay a fair tax we can lower our premiums, increase our benefits, or pay higher dividends to our policyholders, and at the same time increase the amount of capital we can provide to the American economy.

We are very pleased about, and I might say proud, of the eminent and respected members of this committee that have cosponsored H.R. 6045.

Admittedly, this is a temporary solution. It is intended to be a temporary solution. But it will give us time to work on the permanent solution.

We look forward to working with this committee in developing a new piece of legislation to replace the 1959 law. We believe legislation can be developed that will provide sufficient income to the Government, be fair to the life insurance industry, and will keep the life insurance industry competitive among itself and also with other financial institutions, will keep the price of life insurance reasonable for the vast majority of our policyholders, who are of modest means and, finally, will provide long-term financing for America's economy.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

SUMMARY

The American Council of Life Insurance ("ACLI") is pleased to have the opportunity to present its proposal for interim federal income tax legislation for the life insurance business before the House Committee on Ways and Means. The ACLI represents over 524 life insurance companies, which account for 96 percent of the life

insurance in force in the United States, 99 percent of the reserves for insured pension plans and 97 percent of the assets of all life insurance companies in the United States.

Life insurance companies are taxed under special provision of the tax code that have been unchanged since 1959. Economic stresses that have occurred since that time—most especially, the soaring rate of inflation—have exposed serious flaws in the 1959 Act that were not apparent under more stable economic conditions.

We have worked for the last several years to develop proposals to make needed changes in the 1959 Act, and have discussed our proposals with members of the Committee on Ways and Means, the Senate Finance Committee, members of your staffs and of the staffs of the Treasury appeared before you earlier this year and proposed changes that affect the tax treatment of companies using modified coinsurance arrangements. The result would be a tax increase effective January 1, 1982 of nearly $2 billion per year. This would be due to companies losing deductions of about $4 billion for price adjustments they pay to their policyholders in the form of dividends. We oppose such a drastic loss of deductions, and urge instead consideration of proposals that would result in a lesser loss of deductions and in a tax increase of about $1 billion per year, an increase of about 60 percent from current levels.

We concluded early this year that Congress was not likely to be able to give a full review to the 1959 Tax Act during 1982. We felt that such a review might be accomplished in a two year period and searched for a way to set a satisfactory limit on taxes during that period. The "stopgap" proposal described below is designed to provide some degree of tax relief for the industry, while still producing levels of revenue substantially above those currently being paid. This proposal achieves those goals by correcting a number of the obvious breakdowns in the 1959 Act while maintaining its basic structure. During the two-year period covered by the stopgap (tax years 1982 and 1983) we hope that Congress will work with the Treasury and with us to develop the more permanent solution to the tax problems of the life insurance industry.

The basic changes to the 1959 Act incorporated in the stopgap proposal are as follows:

1. SPECIFIC LIMITS ON THE AMOUNT OF DEDUCTIONS THAT CAN BE DISALLOWED BY SECTION 809(F).

We would propose three changes to Section 809(f) to ensure that companies can deduct a reasonable level of those items such as dividents paid to policyholders. Without the proposed changes, companies could lose about half of these deductions.

(a) Qualified Pension Plans.—When the 1959 Act was passed, Congress clearly expressed its intent that investment income attributable to insured pension plans should be tax-free. Today, at least part of this income often results in a significant tax. Much of this tax is a result of the limitation on dividend deductions imposed by Section 809(f) of the current law. This provision acts to penalize policyholders of companies that seek to pay out investment income earned on qualified funds through the mechanism of policyholder dividends.

Our proposal would correct this problem by providing a 100 percent deduction for dividends and similar distributions attributable to qualified pension plans (whether funded with insurance policies or annuities).

(b) Other Insurance and Annuity Contracts.—Under the 1959 Act as originally implemented, approximately 90 percent of all other policyholder dividends were deductible. Today, effective deductions for such dividends have fallen to less than 60 percent because of the interaction of inflation, high interest rates and the provisions of the 1959 Act. If life insurance companies are to remain competitive, they must be allowed to reflect better investment performance by price reductions in the form of lower premiums or higher dividends. Their inability to do so because of lost tax deductions would result in declining attractiveness of permanent life insurance as a savings vehicle.

Our proposal seeks to correct the problem of the declining dividend deduction by assuring a minimum deduction of 80 percent or 87½ percent for policyholder dividends and for nonparticipating special deductions. The level of this deduction would depend on whether a company does business in, respectively, a mutual or stock form. The differential between mutual and stock companies reflects the differing ownership nature of these two types of companies and responds to the theory that some part of the dividends received by policyholders of mutual companies is a return on their equity in the company.

Our proposal would also provide a safety net for deductions that companies could take for amounts of excess interest (interest above the permanent guarantees) used to increase benefits for policyholders. These excess interest credits are currently being fully deducted by the companies, but such deductions could be threatended in the event of an adverse ruling by the Internal Revenue Service to the effect that deductions for such credits must be limited as if they were dividends to policyholders. Thus, our proposal would permit our policyholders to receive the advantage of price reductions either through dividends or through excess interest credits with corresponding reductions in the companies' tax bases.

(c) Small company treatment.—Under the 1959 Act, all companies receive a full deduction for at least $250,000 of their policyholder dividends and other special deductions. This dollar amount figure has been unchanged in 23 years. Our proposal would increase the $250,000 amount to $1 million to take account of the inflation that has occurred in the intervening years. This change would restore the assistance to small companies provided by this deduction to a value equivalent to that of the 1959 provision.

2. A CHANGE TO THE GEOMETRIC MENGE FORMULA

The 1959 Act allows each company to exclude from investment income an amount required to be set aside to increase its life insurance reserves. The amount of this exclusion is determined according to a complex mathematical calculation that is referred to as the "arithmetic Menge", or "arithmetic 10-for-1" reserve adjustment rule.

This arithmetic 10-for-1 rule works reasonably well so long as the differential between assumed and adjusted reserve rates is small—as was the case in the interest climate of the late 1950's. This arithmetic formula breaks down, however, once the differential exceeds a few percentage points.

Our proposal would replace the arithmetic reserve adjustment method with a "geometric" version of the 10-for-1 rule. The geometric rule would provide relief from the clear inaccuracies under the present rule. This change simply carries out the stated intent of the rule imposed under the 1959 Act in a fashion more responsive to today's economic conditions.

OTHER MATTERS

The Treasury Department has proposed legislation that would end the unintended effects of Section 820, relating to modified coinsurance. The ACLI would not oppose a proposal along these lines provided that it does not result in returning the life insurance business to its 1979 position—that of losing half of the deductions (such as dividends to policyholders) subject to Section 809(f) limitations.

Moreover, while the ACLI would not oppose a Treasury proposal to end the unintended effects of Section 820, we would strongly urge that there be a grandfathering provision in the Treasury proposal that would remove doubt about the tax treatment given companies using the Section 820 election in years prior to 1982.

Additionally, our proposal would clarify an additional point relating to the tax treatment given companies in years prior to the stopgap period. Our proposal would clarify, for these prior years, that excess interest credited to policyholders is fully deductible.

Finally, our proposal would seek legislative clarification of the treatment of consolidated tax returns filed by two or more life insurance companies. Absent such clarification—whether legislative or through appropriate regulations—some companies would be unable to take the level of deductions afforded by our proposed changes in Section 809.

This stopgap proposal is the culmination of many months of serious internal negotiations and discussions with both Treasury and Congressional staffs. It is the result of many difficult compromises which had to be made to balance the interests of our diverse membership and to develop a reasonable level of revenues. This proposal has been approved by the ACLI's Board of Directors and is supported by both stock and mutual companies throughout the country. If adopted, it would result in tax revenues from the life insurance business being $1 billion higher for 1982 than if no changes were to be made in the current law. Our industry is proceeding on a unified basis to continue earlier discussions with Congressional taxwriters and the Treasury on this important tax policy issue.

STATEMENT

My name is Robert F. Froehlke, and I am the President of the American Council of Life Insurance ("ACLI"). I am pleased to be before the Committee on Ways and Means this morning to respond to the Treasury proposal to change the tax treatment of life insurance companies using modified coinsurance arrangements, to discuss the problems of the current tax law which have been reduced by the use of such arrangements, and to present the ACLI's proposal for interim federal income tax legislation for the life insurance business. The ACLI represents 524 life insurance companies, which account for 96 percent of the life insurance in force in the United States, 99 percent of the reserves for insured pension plans and 97 percent of the assets of all life insurance companies in the United States.

Earlier this year the Secretary of the Treasury appeared before the Senate Finance Committee with a proposal to change Section 820 of the Internal Revenue Code in such a way as to eliminate the tax consequences that flow under the current law from the use of modified coinsurance arrangements. The proposal was to be effective January 1, 1982 and would increase the taxes payable by the life insurance business by nearly $2 billion per year. We urge that such legislation not be enacted except as part of a package with some other needed changes in the law. Otherwise life insurance companies would be put back in the position they were in during the last half of the 1970's. They would be faced with a tax that had grown and was continuing to grow far faster than their operating gains. They would be unable to reduce the prices charged for individual life insurance to reflect fully the high interest rates currently being earned. The taxes would result in higher prices for policyholders. There would eventually be less funds accumulated through the sale of individual life insurance policies that could be used as long term capital.

The reason that life insurance companies were experiencing severe tax problems at the end of the 1970's is that life insurance companies are taxed under special provisions of the tax code that have been unchanged since 1959. But in recent years soaring inflation and historically high interest rates have revealed serious flaws in the 1959 Act, with the following results: (1) the share of corporate income taxes paid by life companies almost doubled from 1959 to 1978; which led to (2) widespread use of an election under Section 820 that reduced the taxes payable by many companies; and (3) a unified industry effort to develop proposals to revise the 1959 Act.

Over a period of several years we had developed rather extensive proposals for changes we felt to be needed in the 1959 Act. During the latter part of 1981 we discussed our proposals with members of your Committee, members of the House Committee on Ways and Means and members of the staff of the tax writing committees and of the Treasury. As a result of those discussions, we concluded that it was not likely that Congress would have time to complete a thorough review of the 1959 Act during 1982. We also concluded that Treasury would find the level of taxes payable by life insurance companies unacceptably low if nothing were to be done about Section 820. Therefore, we have developed an interim, stopgap, proposal to provide some degree of tax relief for the industry, while still producing levels of revenue substantially above those currently being paid. The proposal achieves those goals by correcting a number of the obvious breakdowns in the 1959 Act while maintaining its basic structure. During the two-year period covered by the stopgap (tax years 1982 and 1983) we hope to work with you and your aides and with Treasury Department staff to help you to develop a more permanent solution to the critical tax problems of the life industry.

The stopgap proposal incorporates the following two major features:

1. Changes to Section 809(f) of the Internal Revenue Code which currently severely limits the extent to which mutual life insurance companies may deduct the dividends they pay to their policyholders and also the extent to which stock life insurance companies may deduct dividends they pay to their policyholders and other deductions available with respect to certain nonparticipating contracts—contracts which don't provide for dividends. These changes would set minimum levels of deductions that would be permitted even if they resulted in reducing gains from operations below the amount of taxable investment income less $250,000. Thus, companies would not lose 100 percent of such deductions as they do under current law. This would be of particular importance to some stock life insurance companies currently using excess interest credits to increase benefits to their policyholders if the Internal Revenue Service were to rule that such credits must be treated as dividends for tax purposes.

2. A change in the reserve adjustment formula used to calculate taxable investment income under the current law. The formula in the current law is an approximation that grows progressively worse as the spread between current earnings rates

and the interest rates used in reserve calculations increases. The result of the error is to overstate taxable investment income dramatically at the levels of interest rates currently being earned and to drastically reduce the extent to which companies may take the deductions limited by Section 809(f).

We would also propose some procedural provisions to help reach these results for companies in different tax situations. These would include some grandfathering provisions and provisions dealing with methods of consolidating income tax returns for two or more life insurance companies. Our proposed changes would permit life insurance companies to reflect current high interest rates in price reductions and to be able to deduct at least 80 percent of the dividends they actually pay to their policyholders.

BACKGROUND

The current problem.—The federal law taxing life insurance companies (the 1959 Act) does not work responsibly in an inflationary environment. A comparison of life insurance company federal income taxes to other economic measures of growth of the life insurance business and to the taxes and economic growth for all other corporations clearly illustrates this point.

For example, from 1960 to 1978 while the federal income taxes of life insurance companies increased 6 times, their gain from operations after taxes increased only 4 times. During the same period, permanent life insurance premiums and reserves increased only 2½ times, permanent life insurance in force increased 3½ times and non-pension assets increased only 2½ times.

In contrast, during this same time span the federal income taxes of all corporations grew 3 times while the income of these corporations after taxes grew 4½ times, gross national product grew 4½ times and personal income grew 4½ times.

What these figures illustrate is that, over this period: The life insurance business bore an ever-increasing share of the general corporate tax burden; from 2.4 percent in 1958 (the first year for which the 1959 Act was generally in effect) to 4.2 percent in 1978, a 75 percent increase; the taxes on the life insurance business grew faster than its gain from operations; and permanent life insurance suffered from a depressed growth rate.

The predicament of permanent life insurance is very significant for our economy. During 1980 life insurance companies added about $9 billion to their reserves for permanent life insurance. This inflow of capital funds would have been about $18 billion in that year if the reserves had merely grown in proportion to GNP.

Moreover, the role of life insurance companies as a source of long-term investment capital is longstanding and major. In 1980, life insurance companies provided 30 percent of all funds raised by American business through corporate bonds and commercial and industrial mortgages.

Why is the 1959 Act not working? The Act is not working because, in 1959, little attention was paid to the possibility that interest rates would rise to their present inflated levels and to how the law would function in such an inflationary environment. While it is evident that inflation and high interest rates have adverse impact of varying degrees on all parts of the economy, high interest rates have particular significance in the life insurance tax law, because of the law's heavy reliance on investment income in its basic formula. Under this formula, as the rate of investment return increases due to inflation, a higher and higher percentage of investment earnings become subject to tax whether or not these investment earnings are devoted to price reduction in the form of dividends paid to policyholders. Specifically, since 1959, the portion of the investment income earned on reserves for permanent life insurance that is taxable has increased 2½ times. The increasingly higher taxes mean that a lower and lower percentage of investment earnings can actually be paid to policyholders as dividends.

Companies writing non-participating contracts, those under which policyholders are not eligible to receive dividends, have developed other methods to reflect current high interest rates in the pricing of their contracts. One method has been through direct reductions of premiums. Companies may charge for some contracts a premium rate of $12 per year per $1,000 of insurance which would be adequate if current trends continue. However, they may be unable to guarantee such a rate indefinitely; therefore, they reserve the right to increase the rate in the future but not beyond a ceiling of say $20 per year per thousand. An alternate approach is to guarantee that an interest rate of say 4 percent per year will be credited to a contract and that excess interest will also be credited as determined by the company in future years in order to set various benefits in the contract. Currently total amounts

of interest in the range of 10 percent or 12 percent may be credited under these contracts.

Currently such methods of reflecting higher interest rates in prices charged by companies for non-participating contracts apparently are fully deductible. That is, the premium actually charged is included in the income of the company—not the maximum premium the company has the right to charge. Correspondingly, the insurance company is able to deduct fully any excess interest it credits to policyholders. However, the Internal Revenue Service is currently considering regulations which might change this status. If such regulations are issued, companies might lose these deductions entirely because of the limitations imposed by Section 809(f). Under these circumstances, life insurance companies would be unable to reflect current high interest rates in their policyholders' costs by increasing dividends, by increasing benefits through excess interest credits or by reducing premiums.

High interest rates—and the resulting competition for investment dollars—has also greatly aggravated flaws in the current tax treatment of other insurance company product lines. Of specific immediate concern is the tax treatment of insurance contracts used to fund plans providing qualified pension benefits.

The present law.—To appreciate why the 1959 Act is no longer working requires some understanding of its mechanics. A basic feature of the Act is its use of a three phase tax computation. The three phases under that computation are:

Phase I, which is a calculation of taxable investment income. As explained below, the primary function of Phase I is to establish a limit on the extent to which certain deductions may be taken in computing the company's tax base.

Phase II, which is a calculation of the company's total gain from operations including both investment and underwriting income. This, plus Phase III, represents the company's tax base. In this computation, recognition is given to the need for companies in certain situations to make additional provision for future adverse fluctuations beyond the normal reserve. Specifically, special deductions are provided for non-participation insurance, accident and health and group life insurance. In addition, only one-half of the excess, if any, of gain from operation over taxable investment income (such excess may be thought of as underwriting gain) is taxed currently.

Phase III, which is an account to which the special deductions and non-taxed half of underwriting gain is posted. If this amount exceeds specified limits or is used to make a distribution to stockholders, such excess of such distribution (plus taxes thereon) is included in the tax base.

In 1978, taxable investment income as computed under Phase I for the life insurance business was about $6.5 billion. For some companies, an excess of gain from operations (in Phase II) over taxable investment income caused the tax base to be higher than taxable investment income by $100 million in aggregate. For other companies, a lower gain from operations caused the tax base to be lower than taxable investment income by an aggregate $400 million. Phase III distributions added about $5 million to the tax base.

Thus, although the mechanics of the 1959 Act would make it appear that the life insurance company tax base is total income, in fact, the tax is, very largely, levied on investment income—without regard to profits. As interest rate levels have moved substantially upward over the past 20 years, the level of taxes on the industry has increased much more rapidly than has the industry's "bottom line" (i. e., gain from operations). As developed more fully in the following pages, this increasingly progressive tax arises because of a number of aspects of the 1959 Act: (1) The mechanics of the Act result in unreasonably limiting the deduction a company can take for: (a) dividends paid to policyholders and (b) other so-called special deductions as defined in IRC section 809(f), particularly the deduction for nonparticipating contracts; (2) The operation of the Act often results in a tax on insured pension plans, whereas non-insured plans pay no tax; and (3) The act contains a technical flaw which, under current conditions, produces an inaccurate deduction for reserve interest requirements.

Each of these problem areas is addressed in our stopgap proposal as discussed below.

THE ACLI STOPCAP PROPOSAL

Liberalize the present limitation on deductions for dividends to policyholders and other special deductions.

The tax treatment to be accorded dividends to policyholders was one of the major issues confronted by the framers of the 1959 Act. There was concern that if divi-

dends to policyholders were deductible in full, the tax liabilities of mutual companies could be substantially reduced and revenue targets could not be met.

This problem was resolved in the 1959 Act by allowing deductions for some dividends to policyholders but providing a floor below which dividend deductions would not be alllowed. That floor was "taxable investment income", which was to be separately computed, less $250,000. The result is that life insurance companies are permitted deductions for policyholder dividends in determining their taxable gain from operations, but those dividends are not allowed to reduce the tax base below taxable investment income less $250,000. [In any event, policyholder dividends up to at least $250,000 are allowed as a deduction in all cases.]

As a result of the operation of these provisions, "taxable investment income" became the key to determining the extent to which dividends to policyholders and other special deductions are deductible. In turn, taxable investment income is controlled in large measure by the formula used to determine the exclusion from investment income related to life insurance reserves. As will be explained in more detail (pp. 15 to 19 of this statement), Congress grounded this formula in the use of each company of its actual earnings rate to be applied against its own life insurance reserves revalued, according to a complex mathematical adjustment referred to as the "10-for-1" or Menge rule, to that earnings rate.

In the early years following enactment of the 1959 Act, actual earnings rates hovered only slightly above assumed rates, and were relatively stable. Hence only modest adjustments had to be made to life insurance reserves in determining the required interest exclusion and the level of "taxable investment income" produced was low enough to permit the deduction of over 90% of dividends to policyholders and other special deductions. Thus, while life insurance companies paid significant taxes, the formula worked to allow tax recognition of the substantial portion of earning that had to be credited to reserves or returned to policyholders through dividends.

In recent years, however, inflation and the resulting soaring interest rates have had drastic effects that could not have been foreseen by Congress. A chief result has been a sharp drop in the proportion of investment income excluded from the tax base because of increases in life insurance reserves and a resulting dramatic increase in taxable investment income. Since taxable investment income sets the limit on the deduction of policyholder dividends and other special deductions that may be taken in determining gain from operations, those deductions have been drastically reduced. Effective deductions for policyholder dividends fell from 90 percent in 1959 to about 60 percent in 1978. When all special deductions subject to elimination by Section 809(f) are considered, the effective level for 1978 fell to 50 percent. In essence, the present law has limitations which deny tax deductions for increasing portions of policyholder dividends and thus penalize policyholders of companies who pay dividends to reduce the price of insurance because favorable experience has made the premiums charged more than was actually needed.

As indicated previsously, some companies have used excess interest credits or indeterminate premiums in order to be able to reflect current high investment returns in their pricing. If the Internal Revenue Service does rule that such excess interest credits must be treated as dividends for tax purposes, the consequences would range from a substantial increase in the price of the products to the insolvency of some companies.

ACLI proposal.—We would propose three types of changes to Section 809(f) to ensure that companies are allowed to take a reasonable level of deductions during the stopgap period.

(a). Qualified pension plans.—When the 1959 Act was passed, Congress clearly expressed its intent that investment income attributable to insured pension plans should be tax free. Today, at least part of this income often results in a significant tax. Much of this tax is a result of the limitation on dividend deductions imposed by Section 809(f) of the current law. This provision acts to penalize policyholders of companies that seek to pay out investment income earned on qualified funds through the mechanism of policyholder dividends. This result is clearly contrary to the Congressional intent referred to above.

Our proposal would correct this problem by providing a 100 percent deduction for dividends and similar distributions attributable to qualified pension plans (whether funded with insurance policies or anuities).

(b). Other Insurance and Annuity Contracts.—As discussed previously, under the 1959 Act as originally implemented, approximately 90 percent of all other policyholder dividends were deductible. Today, effective deductions for such dividends are less than 60 percent. If life insurance policies are to remain attractive, insurance companies must be allowed to reflect better investment performance by price reduc-

tions in the form of lower premiums, higher dividends or increased benefits. Their inability to do so because of losses of tax deductions through Section 809(f) has resulted in declining attractiveness of permanent life insurance as a savings vehicle.

Our proposal seeks to correct the problem of the snowballing of lost deductions because of Section 809(f) by assuring a minimum deduction of 80 or 87½ percent for policyholder dividends and the nonparticipating special deductions. The level of this deduction would depend on whether a company does business in, respectively, a mutual or stock form. The differential between mutual and stock companies reflects the differing ownership nature of these two types of companies and responds to the concept that some part of the dividends received by policyholders of mutual companies is a return on their equity in the company.

This approach would clearly help companies to pass through price reductions by increasing dividends since they would be assured of some resulting tax deduction. It would also help companies using premium reductions or crediting excess interest in the event that the Internal Revenue Service makes an adverse ruling and such a ruling is not overturned. Thus, if the Internal Revenue Service holds that excess interest is to be taxed as if it were a dividend to the policyholder, it would be caught by the safety net and a stock life insurance company would risk losing 12½ percent of the deduction rather than losing the entire deduction.

(c) Small company treatment.—Under the 1959 Act, all companies receive a full deduction for at least $250,000 of their policyholder dividends and other special deductions. This dollar amount figure has been unchanged in 23 years; our proposal would increase the $250,000 amount to $1 million to take account of the inflation that has occurred in the intervening years. This change would restore the assistance to small companies provided by this deduction to a value equivalent to that of the 1959 provision.

Correct Inaccuracies in the Revaluation of Statutory Reserves by Replacing the Present Approximation Formula with a Geometric Ten-For-One Rule and a 9.5 percent Valuation Cap.

The 1959 Act allows each company an exclusion from its net investment income related to its life insurance reserves. To prevent taxes from varying disproportionately in accordance with reserve assumptions that can vary from company to company, the law provides a uniform procedure to be followed by each company in determining the investment income subject to this inclusion.

First, looking to the actual earnings rate on its assets the company determines its adjusted reserves rate. This rate is simply the lower of the current earnings rate on its assets or the average earnings rate over the past five years.

Next, the company reconstructs its life insurance reserves (which are grounded in interest assumptions limited by state law) to restate in effect those reserves as they would have been if the adjusted reserves rate of the company had been used by it in establishing them. This adjustment generally requires a reduction in life insurance reserves. Finally, the company multiplies its revalued reserves by the adjusted reserves rate and this produces its exclusion from net investment income.

Critical to this three step process is the method to be used for revaluing life insurance reserves to the adjusted reserves rate. Ideally, this would be accomplished through an exact revaluation. But, as the framers of the 1959 Act understood, an exact revaluation of a company's life insurance reserves to the adjusted reserves rate would entail massive effort and detailed analysis that would not be technically feasible for many companies and that, where feasible, would involve onerous costs. Such a calculation would be required each time an Internal Revenue Service auditor disallowed something that would change the earnings rate for any of the tax years used to calculate the current earnings rate of the company. Rejecting exact revaluation as impractical and uneconomic, Congress sought a simpler alternative that would reasonably approximate the result of exact revaluation. It settled on the 10-for-1 rule, an actuarial approximation used for many years by insurance actuaries to reasonably approximate changes in amounts of aggregate reserves due to small changes in valuation interest rates. Under the 10-for-1 rule life insurance reserves are revalued to the adjusted reserves rate by reducing them by 10 percent for every 1 percent which the adjusted reserves rate exceeds the assumed rate.

The Senate Finance Committee illustrated the application of this rule with an example of an adjusted reserves rate of 3.75 percent and reserves of $900,000 established at an assumed rate of 2.5 percent. Thus, the $900,000 of reserves is reduced to $787,500. The company's exclusion is $787,500 multiplied by 3.75 percent or $29,531.

Congress viewed the 10-for-1 rule in the context of the interest climate of the late 1950's and accepted it as a reasonably accurate means of approximating the results of exact revaluation so as to restate life insurance reserves "as they would have

been if the average earnings rate of the company . . . has been used by the company in establishing these reserves." (S.Rep. 291, 1959-2CB at 781).

Had Congress forseen the extraordinary rise in interest rates that has culminated in the interest climate of the 1980's and in the U.S. Treasury paying in excess of 13 percent on long-term debt, it would likely have selected an approximation rule more sensitive to high interest rates. As a means of approximating the reserve that would be produced by exact revaluation, the 10-for-1 rule works reasonably well so long as the differentials between assumed rates and adjusted reserves rates are small—as in the Senate Finance Committee example. The rule is flawed, however, in that demonstrable distortions and inaccuracies appear once the differential exceeds a few percentage points and these distortions grow progressively worse as interest rates increase.

While average reserve interest assumptions have increased only slightly over the past twenty years (partly because of state law limitations but more due to large portions of reserves attributable to policies written years ago), actual earnings rates which make up adjusted reserve rates have climbed sharply. With industry adjusted reserve rates now about 8 percent and increasing, while average assumed rates barely exceed 3 percent, the 10-for-1 rule is producing serious mathematical distortions and artifically low reserve approximations. With the breakdown of the 10-for-1 rule in the present environment, life insurance companies are losing substantial portions of the reserve interest exclusion intended by Congress and are paying much higher taxes because of artificially inflated taxable investment income that results. This is the source of much of the increase in lost deductions resulting from Section 809(f).

Marginal rates of tax on corporations generally are limited by the corporate tax rate of 46 percent. This is not so for life insurance. For example, under the operation of the present 10-for-1 rule marginal rates on additional dollars of investment income arising from increased earnings rates have moved past 46 percent. The marginal tax rate on additional investment income will exceed 46 percent when a company's average investment earnings rate exceeds 6½ percent (assuming a 3 percent assumed rate in computing reserves) and will climb steadily as the average investment earnings rate continues to increcase. If the average earnings rate reaches 10 percent, the marginal tax rate on additional investment income will exceed 73 percent. This means that higher interest rates will inexorably force up the taxes paid by life insurance companies by nearly 75 cents for each additional dollar of investment income even though the companies actually use those dollars to pay dividends to the policyholders, reduce premiums or increase benefits. The only relief from this prospect would be through continued use of reinsurance contracts, if the law is unchanged or through the adoption in changes in the law to amerliorate the impact of Section 809(f).

ACLI proposal.—The ACLI proposal would substitute for the existing arithmetic 10-for-1 formula a modified formula which may be referred to as a "geometric 10-for-1" rule. It produces, in a simple calculation, a much better approximation to an exact revaluation of reserves at the high earnings rates prevailing. The arithmetic 10-for-1 is replaced by $.9^n$ as the multiplier, in which n is the number (positive or negative) determined by subtracting—(1) the number 100 times the fraction equal to the average rate of interest assumed by the taxpayer in calculating the reserves, from (2) the number 100 times the adjusted reserves rate.

Thus, if the average rate of interest assumed is 3 percent, or .03, and the adjusted reserves rate is .08, then n is 5 (100 times .08, minus 100 times .03).

Under the proposed amendment, the adjusted earnings rate may not exceed .095. Without this limit the approximation to an exact revaluation would become worse. The policy and other contract liability requirements would begin to drop as the adjusted earnings rate rose over .095 with the result that the marginal tax rate on increased investment income would exceed the general corporate rate.

The change from the arithmetic 10-for-1 to the geometric 10-for-1 would apply for taxable years beginning in 1982 or thereafter.

Examples of the application of existing law and of the ACLI proposed revision are shown on the following page.

EXAMPLES OF 10-FOR-1 CHANGE

Assume:			
Mean of reserves	$800,00	$800,000	$800,000
Adjusted reserves rate (percent)	7.5	10.0	3.0
Average rate of interest assumed	3.5	3.5	3.5

EXAMPLES OF 10-FOR-1 CHANGE—Continued

Result under existing law:			
Existing law multiple (percent)	60	35	105
Adjusted reserves	$480,000	$280,000	$840,000
Adjusted reserves rate	7.5	10.0	3.0
Amount included in policyholder and other contract liability requirements	$36,000	$28,000	$25,200
Results under proposal:			
Multiply by	$(.9^4)=.6561$		$(.9-^{.5})=1.0541$
Adjusted reserves	$524,880		$843,280
Amount included in policyholder and other contract liability requirements	$39,366		$25,298
9.5 percent ceiling:			
Multiply by 0.9 to the power (9.5–3.5)		$(.9^6)=.5314$	
Adjusted reserves		$425,153	
Amount included in policyholder and other contract liability requirements (9.5 percent of adjusted reserves)		$40,390	

Procedural matters.—As stated previously, we would not oppose the general thrust of a Treasury proposal to end the unintended effects of Section 820 provided that it did not result in companies losing forty or fifty percent of deductions subject to the limitations of Section 809(f). This could be avoided by enactment of stopgap legislation along the lines we propose. With regard to ModCo arrangements entered into in years prior to 1982, we would strongly urge that the Treasury proposal be expanded to include a grandfathering provision that would remove doubt about the tax treatment given companies using the Section 820 election. We would not want current legislation to affect past years adversely.

Our proposal would also clarify an additional point relating to the tax treatment given companies in years prior to the stopgap period. Our proposal would clarify, for these prior years, that excess interest on all products is fully deductible, and that indeterminate premium products do not give rise to "phantom premiums".

Finally, our proposal would include a provision dealing with the basis on which consolidated tax returns filed by two or more insurance companies would be computed. We have urged Treasury that regulations be issued on the subject, but such regulations have not been released. Absent appropriate regulation, companies in a tax situation in which one company of a group is in a phase II positive tax situation (its gain from operations exceeds its taxable investment income) would be unable to take the level of deductions that would be provided by our proposed amendments to Section 809(f). This result would obtain regardless of which company in the group wrote the policies. This would make it impossible for companies in such groups to compete effectively for such business with other companies who could take the full deductions proposed. For this reason, we would ask for clarifying legislation unless appropriate regulations are developed and issued.

Mr. Chairman, the stopgap proposal I have just described is the culmination of many months of serious efforts and reflects points raised in discussions with both Treasury and Congressional staffs. It is also the result of many difficult compromises which had to be made to balance the interests of our diverse membership and to develop a level of revenues that we hope would be acceptable. Inasmuch as this two-year measure is only temporary, however, pressure would still be maintained to arrive at a long-term solution to the problems of the current life insurance tax law.

The stopgap proposal has been approved by the ACLI's Board of Directors and is supported by both stock and mutual companies. If adopted, it would result in tax revenues from the life insurance business being $1 billion higher in 1982 than if no change were made in the current law, about a 60 percent increase. Our industry is proceeding on a unified basis and, I believe, in a positive fashion to communicate with your committee and your colleagues in the Senate, as well as with the Treasury, on this important tax policy issue.

I appreciate having this opportunity to outline the concerns of the life insurance business over the manner in which we are taxed and our recommendations for dealing with this situation. I will be pleased to respond to whatever questions you may have.

REVENUE EFFECTS OF THE PROPOSAL

Before 1978, the total taxes on life insurance companies could be predicted simply by estimating investment income which reflected the gradually improving asset base and investment return. This could be done because the tax base was almost entirely investment income.

The approach in the stopgap proposal will decrease this historical predictability of the life insurance tax yield. Most companies will be developing their tax liability from the gain from operations before dividends less 80 or 87.5 percent of policyholder dividends. This means that special operational results of each year, such as health insurance losses or gains, will affect the tax base, which is normal in other industries. One doesn't say that the formula for taxing banks is "wrong" because the total tax on banks is low in a year when most banks have losses. One evaluates the tax on banks from the experience over several years.

Despite these uncertainties, we have provided revenue estimates for our proposal in Table 1. There are several particular important numbers there.

$2.7 billion which we think would be collected under our proposal; $1.7 billion which would be collected under present law; and $4.0 billion which are hypothetical collections under present law without ModCo.

First, some comments on the hypothetical $4.0 billion. The most striking thing about this is that it is significantly below the trend line up to 1978. In 1978, the income tax on life insurance companies was $3.0 billion and increasing about 15 percent a year, on a path that would have brought it to about $5.5 billion in 1982.

Achieving so large a revenue was out of the question for several reasons.

(1) This heavy tax burden has inhibited the growth of permanent life insurance, which is the kind of business that generates most of the tax base.

In the 1950's and early 1960's, ordinary life insurance reserves were growing at about the same rate as the rest of the economy, that is the GNP. The heavy tax burden that had accumulated on this business by 1978 had held the rate down to about half the GNP and since 1978 most companies see their life reserves growing at an even slower rate, some as low as 3 percent a year.

(2) When companies are faced by declining growth rates, they look at a number of responses. One response is to find ways to do business that involve less tax penalty.

Under the present law, a higher rate of interest earnings reduces the life insurance reserve deduction. The companies look for investment strategies that involve lower current rates of return in exchange for, say, long-term capital gain. Real estate is one such investment. Under the present law the restrictions on exempt interest and the dividends received credit are much less severe for casualty insurance companies than for life companies, so increasingly life companies write health insurance in a casualty subsidiary.

(3) One of the measures to reduce the tax burden was to engage in reinsurance arrangements so as to avoid lost deductions. This is what ModCo is all about.

Our best judgment as to what has been happening in the life insurance business is that the combination of lower growth and reorientations of business under present law (in ways uncontested by the Treasury) brings the prospective revenue for 1982 operations under present law down from the growth curve number of $5.5 billion (projected from late 1970's) into $4.0 billion. Further, the use of ModCo reduces this to about $1.7 billion.

The Treasury has used the revenue estimate of $1.8 billion as the effect of ModCo on 1982 tax liabilities. This is slightly below our number but "in the ballpark" of about $2.0 billion. The Treasury has not made public its estimates of the absolute tax level under present law with or without ModCo.

A final comment is that the estimate of $4.0 billion as revenue under present law without ModCo is hypothetical. It is not an estimate that Treasury revenues would increase by $2.3 billion if you simply repealed ModCo. If you move in that way you would be further inhibiting the growth of permanent life insurance, and further pushing companies into selecting investments on the basis of tax effects.

The other important number in our table is the estimate of $2.7 billion as the expected revenue under our proposal. As can be seen, most of the change from the hypothetical present law without ModCo comes from the provisions dealing directly with wasted policyholder dividend deductions.

We have provided some hypothetical numbers for 1983 operations.

A final comment is appropriate.

Underlying all these numbers is an important issue for the growth of savings and capital in the U.S. economy. In 1979 the growth of savings through ordinary life insurance reserves was $10 billion (which is only half of what it would be if it only kept up with the growth rate in GNP). This is the growth rate which we said was

being pushed even lower by the tax burden on life insurance. It is easy to see that even a mild relief from the tax penalty on life insurance can produce a significant improvement in funds flowing into capital markets. If the difference between $4.0 billion and $2.7 billion were viewed as a benefit for life insurance companies and policyholders, it should be looked at in the context of its potential to turn around this flow of savings.

REVENUE PROJECTIONS UNDER STOPGAP

[In billions]

	Annual liability	
	1982	1983
Present law with ModCo	1.7	1.8
Present law without ModCo	4.0	4.3
Stopgap	2.7	3.0
Revenue change:		
From present law without ModCo	−1.3	−1.3
From present law with ModCo	1.0	1.2
Components of revenue change from present law without ModCo:		
Qualified dividend deductions	.07	.08
80/87.5 dividend deduction	1.10	1.10
Liberalized $250,000	.01	.01
Geometric menge	.10	.10
Total	1.3	1.3
Change in fiscal year receipts from present law with ModCo	0.4	1.3

Mr. GEPHARDT. Thank you very much. We appreciate your testimony.

Mr. Conable.

Mr. CONABLE. Mr. Froehlke, I think the insurance industry is to be congratulated in coming forward with a proposal here. We are aware you have had a rather difficult time accommodating the tax laws that have been at the first, unduly burdensome for you, and then have opened a loophole that you had to take advantage of for competitive reasons.

We are aware of the pressure on financial institutions generally, and in the pluralism of the investment processes we have in this country. And that is why many of us have been willing, at least on a temporary basis, to accept the solutions you have come forward with.

But we understand that your situations can be only temporary, and that you are looking for long-term reform while being kept in a competitive position with other financial institutions in a dramatically changing economy.

I hope we can continue to work together to try to achieve that long-term goal. I hope also that my colleagues will be responsive to the specific problems that you have with the tax law as it was being administered, both in terms of loopholes and in terms of undue burdens.

I guess I am just making a statement here. I personally have gone along with the idea that a bird in the hand is worth two in the bush. Because of the specific problems you have had it has been necessary to come forward with some sort of a solution. And I am glad you did it.

I just want to express that opinion for the record.

Mr. FROEHLKE. Thank you very much, Mr. Conable.

Mr. GEPHARDT. Mr. Stark.

Mr. STARK. Mr. Froehlke, for the stock life companies, what would you say their average effective income tax rate is on their net income?

Mr. FROEHLKE. I will refer that one to the expert on my left, Mr. Minck.

Mr. MINCK. Mr. Stark, I would think, again, that the figure will run anywhere from 30 to 50 percent, depending on the treatment of dividends to policyholders in defining economic income.

Mr. STARK. The stock companies, on their net profit, what is their effective tax rate?

Mr. MINCK. Well, I think—and I am talking from memory—that over the last decade, the figure has run from 35 to 45 percent, using Treasury definitions of economic income, depending on which year you were looking at.

Mr. STARK. Including increase in reserves?

Mr. MINCK. Yes, sir.

Mr. STARK. Stockholders' equity, including in net income the stockholders share in increases in reserves?

Mr. MINCK. I believe that is right, sir—the increase in shareholders' equity corresponds to the Treasury definition of economic income. If I may, I would like to go back and give you exact numbers for the record.

Mr. STARK. And for the mutuals, well, that doesn't apply. Except that it is interesting to note in the Senate testimony of GAO, that Prudential, Metropolitan taxes dropped between 1979 and 1980, from 77 percent in the case of Metropolitan and 68 percent in Prudential. They are paying about a third as much income tax in 1980 as in 1975. The rest of the insurance companies had similar reductions, although not as high. They run in the 25 to 30 percent.

Mr. FROEHLKE. May I comment on that? I think that is very important as Mr. Conable earlier pointed out, we are coming front and center now and saying that the use of ModCo the way it has been used in the past 3 years, was not intended——

Mr. STARK. I understand that. I just want to point out there is a tremendous reduction in taxes. The casualty companies are not asking for a tax change, is that correct? They don't have a problem.

Mr. FROEHLKE. That is correct.

Mr. STARK. Would one then be led to believe the only reason the life insurance companies have a problem is because of the ordinary life contract, whole life?

Mr. FROEHLKE. If there is one reason, it is because of inflation.

Mr. STARK. The life insurance company that only sells pure term doesn't have a problem itself, does it? Answer yes or no. It doesn't have a problem, does it?

Mr. MINCK. It has a problem. It is a different problem.

Mr. STARK. It doesn't have a tax problem, does it?

Mr. MINCK. We don't have any members who sell only term insurance. But there are tax problems related to term insurance.

Mr. STARK. Do those who sell 90 percent term have a problem under the 1959 act.

Mr. MINCK. They do in this sense. If I may go over it a moment, the problem with the 1959 act is the limitation on the extent to

which you can deduct dividends that you have paid to your policyholders.

Mr. STARK. Which many people don't really believe are dividends anyway, they are just a reduction in premium.

Mr. MINCK. Yes, sir; that is correct.

Mr. STARK. My point is there may be a case here that your product is no good. In other words, term insurance is competitive, and probably the only insurance being sold. I am perfectly willing to let you guys be even with the banks and savings and loans. But what you are really saying is that since anybody who invested in ordinary life insurance has lost money; it has been a dumb investment over the past 20 years.

You can say that may be due to inflation. But people have invested in real estate or mutual funds, may have done pretty well. So that I am not sure but that what you are asking for is to bail out an inefficient product. If you look at what Merrill Lynch is doing, and what banks are doing, combining money market funds and a whole host of things, maybe your industry is trying to get us to revive a dead horse.

Mr. FROEHLKE. I can assure you, Mr. Stark, our industry sincerely believes that whole life insurance is not a dead horse. Our sales would indicate that any number of the public would agree with us. But finally we also consider it is not an investment.

Mr. STARK. For the record, I disagree. I can prove to any of you that ordinary life insurance is the worst investment an individual can make——

Mr. CONABLE. Provided you don't die.

Mr. STARK. It hoses the public. Let me ask this. On page 16 of your testimony, you say, "Ideally, this reserve accounting could be accomplished through an exact revaluation. But as the framers of the 1959 act understood an exact revaluation to the adjusted reserve rate would entail massive effort and detailed analysis and involve onorous costs."

In 1959 we and the public at large did not have the computer capacity and sophistication we have now. And I would submit to you that exact revaluation is now possible. And I cannot believe that any of you could have an actuary on your staff worth his or her salt that could not, with the aid of computer, go to exact revaluation.

Why shouldn't we head toward that?

Mr. FROEHLKE. I will have the actuary on my staff answer the question.

Mr. MINCK. There are two or three problems with such an approach. One, if you are a very large company, you may have, say, 35 million policies on your books. To revalue each of them you have to run all of your tapes.

Mr. STARK. Takes you what, an hour?

Mr. MINCK. No. Running something like that is a much more expensive item than an hour, I believe, sir. But in any event, you would have to do that once when you file your return, but you may have to do it repeatedly during the process of auditing. Some of our companies have not had a tax year closed since the law was enacted. In the process of auditing, you get things disallowed, and the current earnings rates get changed.

So you would be faced with doing that calculation over again every time a new interest rate came up through the audit process.

Mr. STARK. What about a Federal Reserve rate? Are you so opposed to Federal regulation of your industry you want to let the various States keep setting the reserve rate?

Mr. MINCK. Well, our problem, sir, is that our reserve rates are in our contracts. Once we have issued the contracts, we have no ability to change them.

Mr. STARK. Don't they vary in different States?

Mr. MINCK. No, sir. We have uniformity.

Mr. STARK. If you have a 3-percent contract, it is the same in every State.

Mr. MINCK. Yes, sir.

Mr. STARK. Who sets the amount you have to set aside?

Mr. MINCK. State law.

Mr. STARK. Don't those vary?

Mr. MINCK. No, sir.

Mr. STARK. Every State has the same?

Mr. MINCK. Yes, sir. Except when you are in the course of a transition and a new set of amendments are going through. With respect to the last set of amendments, all 50 States are uniform.

Mr. STARK. Aren't most insurance companies, probably, if you valued your portfolios to market values, upside down, life companies?

Mr. MINCK. We carry both our assets and liabilities according to amortized book values rather than market values, except for common stocks and those sorts of things.

Mr. STARK. But the bond and mortgages are at cost.

Mr. MINCK. Yes. Amortized value.

Mr. STARK. What I am saying is, isn't it a fact, the head of a large life insurance company in California told me basically, it is not very likely, if they had to liquidate they would be a couple of billion short, if they had to sell their bonds and mortgages at market and redeem all their contracts, which again is unlikely, at face value.

Mr. MINCK. I think what you say is right, though I would emphasize the unlikeliness.

Mr. STARK. Banks and savings and loans have the same problem. And I don't really see that as our duty to bail out these industries. I am inclined to think that ModCo has to be part of an overall reassessment, and I would suggest that there are a number of life insurance experts who would take exception, although there are not many ACLI's in this camp, I would be very nervous about making ordinary life competitive through the Tax Code.

In other words, you can build an ordinary contract, as I am sure you are all aware, with decreasing term policy and investment policy. So as long as we are not trying to either do something that creates tax gimmicks that insurance salesmen can peddle, that has gone on in the past, and your industry is not alone in that, and as long as we are not trying to take a product which isn't competitive, say with New York Savings Bank Insurance on a New York State savings bank account, which in effect is an ordinary life type program, it has the same, probably makes a little more money for the investor, or for the client.

But as long as we are not using the Tax Code to in effect give your industry a competitive advantage over something like the savings banks and the savings banks insurance, I would be inclined to join with my colleagues from New York and say we ought to take a look at the overall program.

One last question.

The Treasury's proposal of March 16 really almost accomplished all of the administration's ModCo proposals, did it not? I suspect the Treasury actually has the authority to resolve the whole ModCo problem right now without any legislation. It seems to me like their proposed regulations pretty much do it.

Would you agree?

Mr. FROEHLKE. You can go to the courts. They did make an attempt. But the courts eventually would have to resolve that.

Mr. MINCK. I think, Mr. Stark, some lawyers have expressed the opinion that the Treasury overstepped their authority in some sections of the proposed regulations.

Mr. STARK. I see the debate there. What I am saying, with their proposed regulations, hasn't the administration almost accomplished what they are asking for in their ModCo legislation?

Mr. MINCK. If their regulations held up, I believe it would.

Mr. STARK. OK. I understand there are some people who take exception to that, and this committee might. It might be something we ought to legislate, it might be something that ought to be regulation. But it was my feeling they have almost done it without putting us through all the problems of legislating.

Thank you, Mr. Chairman.

Mr. CONABLE. Mr. Chairman, could I ask one factual question of Mr. Froehlke?

ACLI has a fact book. It shows the total between 1979 and 1980 for the insurance industry went up from $119 to $132 billion. In the same period, income taxes decreased from $3.2 to $2.5 billion.

Now, will there be a further reduction shown for 1981 as a result of the use of the ModCo device?

Mr. FROEHLKE. We don't have those figures. But I would assume there would be a further reduction.

Mr. CONABLE. Because the use of the device is becoming more widespread again, as a result of the competitive factors there?

Mr. FROEHLKE. Yes.

Mr. MINCK. Mr. Conable, just to give you some insight into that, what happened was that in 1979 we had paid to our policyholders more than $7 billion in dividends, and had been unable to deduct more than $3 billion of it because of the way the law works.

In 1980, we were able to deduct all but about $1 billion of the dividends that we had actually paid to our policyholders. That is money our companies returned to their customers. We think in 1981 there would be enough ModCo arrangements in effect so we would be able to deduct all of the dividend we paid to our policyholders or nearly, so there would be an additional reduction because of it.

Mr. CONABLE. Thank you.

Mr. STARK. Mr. Chairman, I would like to ask unanimous consent to submit about half a dozen questions which the staff has helped prepare that are fairly technical, dealing with some of the

ModCo changes and other insurance regulations, and request the witness, if he would, to reply in writing so we could add your answers to the record.

Mr. FROEHLKE. We would be pleased to do so.

Mr. GEPHARDT. Without objection, so ordered.

[The questions and answers follow:]

AMERICAN COUNCIL OF LIFE INSURANCE,
Washington, D.C., April 30, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Enclosed are answers to the questions from Congressman Stark which you sent to me so that our answers could be included in the hearing record. We appreciate your consideration in giving us until now to provide our responses.

I think these questions and answers help to clarify our position. We are anxious to provide whatever information we can.

Sincerely,

ROBERT F. FROEHLKE.

Enclosure.

Question 1. In your view, with the issuance of the Treasury Department's proposed regulations on experience refunds (March 16th), has the Administration effectively accomplished what it is seeking in its modified coinsurance (MODCO) legislative proposal?

Answer. No, the Administration has not effectively accomplished what it is seeking in its MODCO legislative proposal. Although the proposed regulations seek to accomplish essentially the same objectives as the Administration's legislative proposal, the proposed regulations fail to do so because they are invalid and conceptually flawed. We expect that the proposed regulation, if adopted, will eventually be struck down by the courts because they contradict the statute that they are intended to interpret.

The proposed regulations are invalid not only because they contradict the statute, but also because they would produce unreasonable and arbitrary results. For example, the proposed experience refund rules could result in a greater overall tax burden than would have been imposed upon the ceding company if there had been no reinsurance. The rules also could result in an overall reduction of taxes. Moreover, the proposed regulations would have adverse effects on long-standing and nontax motivated reinsurance transactions far outside any area of perceived abuse.

We also believe very strongly that any attempt to address the serious flaws in the 1959 Act through piecemeal amendments to longstanding regulations on reinsurance transactions is ill-advised. Any change in the current tax rules, whether short-term or permanent, must take a broader view of the problem. This can only be accomplished through a legislative change.

Finally, if the proposed regulations were adopted in their present form, they will almost certainly be challenged in court and will be the subject of prolonged litigation. Thus, the proposed regulations cannot provide a final answer to the current controversy about modified coinsurance. Certainty is needed, not years of litigation, and certainty can be provided only by legislation.

Question 1a. Although your stopgap proposal includes the repeal of section 820, we note that there is no provision for any special treatment of experience refunds paid under conventional coinsurance agreements as is proposed by Treasury. What comments do you have on the breadth of Treasury's proposed legislation in this regard?

Answer. We should record first that our proposal is for only suspension of section 820 until a basic revision of Subchapter L is developed.

The proposed regulations would upset long-standing conventional coinsurance agreements by attempting to divide experience refunds into one portion that is investment income and a second portion that is premium income. Under the modified coinsurance election, the ceding company and the reinsurer may elect that investment income on assets held by the ceding company be taxed to the reinsurer. Under conventional coinsurance, the assets involved are actually held by the reinsurer and it follows under basic tax law principles that the investment income on those assets is the investment income of the reinsurer. In dealing with coinsurance, the Treas-

ury has failed to recognize that the problem under present law is not coinsurance but the mechanism of the 1959 Act which taxes companies differently depending on their particular mix of investment income and other income. When assets are held by the reinsurer, the investment income from these assets should be treated as the investment income of the reinsurer.

Question 2. You have indicated that recent high interest rates and the workings of the so-called "10-to-1" formula for setting asset reserve deductions have caused marginal rates on company taxable investment income to increase sharply. Hasn't the industry more than offset this effect by the tremendous growth in reinsurance—as GAO testifies in the Senate hearings?

Answer. The industry, in aggregate, has offset the overtaxation under the 1959 Act by reinsurance, but the Treasury wants to close down these opportunities. The GAO did agree with our position that changes in rules for modified coinsurance ought to be done along with basic revision of the 1959 Act. The GAO testified before the Senate Finance Committee "it is important that the problem of section 820 be considered in light of the substantially changed economic conditions in which the industry currently operates." It should be noted that this offset did not work for all companies.

Question 2a. Does the present adverse effect of the application of the 10-to-1 formula for determining a company's taxable investment income impact differently on mutuals as compared to stock companies?

Answer. The 10-to-1 formula affects the tax paid by those companies whose tax base in whole or in part depends on taxable investment income. This includes almost all mutual companies and most large stock companies. Many smaller to medium size stock companies, however, pay tax on a base of gains from operations rather than on taxable investment income. Therefore, the deficiencies in the 10-to-1 formula affect the tax of most mutuals and larger stock companies, but generally do not affect smaller stock companies. These changes reduce the share of life insurance company taxes paid by mutuals.

Question 2b. If MODCO has been used predominantly by mutual companies to offset the adverse effects of the 10-to-1 formula, what "tax device," if any, has been used by stock companies?

Answer. All companies have utilized a variety of tax planning devices to reduce their overly burdensome taxes, which include devices used by other taxpayers, such as increased investment in assets with capital gain prospects. Stock companies, whose current tax is in whole or in part based on taxable investment income, have also used MODCO.

Question 3. Apparently, the mutual insurance companies benefit most by these MODCO arrangements, since they are the companies that are limited in their dividends paid to policyholders deduction. How does the explosion in MODCO reinsurance affect the competitive balance between stock and mutual companies?

Answer. Most of the insurance companies that benefit from MODCO arrangements are mutual companies, although some stock companies also benefit. Both types of companies have lost increasing amounts of the deductions subject to the limitations of section 809(f) of the Code. For example, in 1978 our stock company members were losing deductions of more than half a billion dollars per year because of that provision. Our mutual companies were losing deductions of about $2.5 billion that year. Therefore, MODCO had more potential for mutual companies, and such treaties reduced their share of the total taxes paid by the business.

An important objective and effect of the stopgap proposal set forth in H.R. 6045 is that it moves in the direction of establishing competitive balance. The industry-wide support for the proposal is evidence of this. There is agreement that all companies should be permitted to compete on a fair basis which does not burden the products sold by one or the other, but which takes account of differences in forms of organization.

Question 4. You point out in your testimony that the 1959 Act adopted an approximate revaluation foumula because an exact revaluation of a company's reserves to the adjusted reserves rate would "entail massive effort and involve onerous costs." How fair is that assumption today in light of advance computer technology, sophisticated software programming and sharply reduced computer costs.

Answer. The assumption remains valid. Many small companies do not have the advance computer resources necessary for exact revaluation. Moreover, the resources even of large companies are already strained by the complex array of new insurance products that have been developed recently. Exact evaluation of reserves relating to all these products would entail onerous costs. Finally, exact revaluation would put great burdens during the audit process on both companies and the Internal Revenue Service. Many changes made during audit could separately affect a

company's actual earnings rate and therefore its revalues reserves. Consequently, reserves might have to be revalued many times during the audit process. In addition, if a Service agent wished to audit a company's revalued reserves, it would be necessary for the agent to examine and understand in detail the complex formulas and computer programs used to make the revaluation. These audit burdens would greatly strain the resources of companies and the Service.

Question 4a. Is it at all possible that, even under an exact revaluation of policy reserves on the basis of the adjusted reserves rate, the exclusion allowed for the policyholders' share of investment income could approach zero if the current earnings (interest) rate became large enough?

Answer. On an exact basis, the policyholders' share of investment income gradually declines but never reaches zero as the interest rate increases to infinity. The minimum policyholders' share on an exact basis depends on a variety of factors, including policy form, issue age, duration and the interest rate.

An indication of the policyholders' share of investment income on an exact basis at probable levels of interest rates is provided in a paper published by the Society of Actuaries. (See, Peter W. Plumley, "Certain Inequities in the Life Insurance Company Income Tax Act of 1959," Transactions of the Society of Actuaries XXVIII.) Table 5 of the paper compares the exact adjustment percentages at various interest rates based on model offices submitted by several large insurance companies. Multiplying these adjustment percentages by the interest rates provides the policyholders' shares of investment income. At a current earnings (interest) rate of 13 percent (the rate that produces a zero policyholders' share under present law when the valuation rate is 3 percent), an exact calculation would result in policyholders' shares of 41 percent to 51 percent after 85 years of level new issues.

Question 5. How much of your current problem is related to relatively low assumed earnings rates set by State law? Should there be a separate Federal law assumed rate for Federal income tax purposes?

Answer. State laws require relatively low assumed earnings rates. This is not only reasonable but prudent since life insurance interest guarantees stretch out for many years into an unknown economic future and climate. It would be unsafe for life companies to assume that today's interest rates will last for 30 or 40 years. The low assumed earnings rates are a problem under existing law. In fact, companies seeking to return today's higher rates to policyholders face taxes at high rates on interest earnings in excess of assumed rates. Nevertheless, there could be serious problems if Federal tax law used one assumed rate and State law another. A company could be insolvent under State law and still be faced with Federal taxes. A separate Federal law assumed rate would require a duplication of all calculations and be contrary to the total thrust of the present administration toward simplification of the requirements placed on individuals and corporations in compliance with Federal laws.

Question 5a. For instance, what would be the problem of calculating the policyholders' share of investment income based on actual reserves and the highest allowable assumed rate, as proposed by GAO in its report of last year?

Answer. It should be noted first that this method was not proposed by the GAO. It was one of three alternatives, including the geometric formula, the GAO set forth for Congressional consideration without recommendation. This method, like any other using a Federal assumed rate, would be unnecessary if the 10-to-1 formula were corrected. Moreover, this method bears no conceptual relationship to the amount of investment income actually credited to reserves, and the GAO itself termed this method arbitrary. Of the GAO alternatives, only the geometric 10-to-1 corrects the defect in the present law 10-to-1 formula without substantially departing from the rationale underlying the policyholder reserve deduction in the 1959 Act. For a fuller discussion of the GAO proposals, see our comments submitted to GAO, reprinted in Appendix VIII of the GAO Report to the Congress, PAD–81–1, September 17, 1981, especially pp. 191–6.

Question 6. As we understand it, the section 820 MODCO election was included by the Senate in the 1959 Act so we would avoid double taxation on the investment earnings under these reinsurance contracts. Could you expalin what the double taxation problem is if there is no section 820 election?

Answer. If there is no section 820 election, it is possible for the same income to be taxed twice—once to the ceding company as investment income and once to the reinsurer as underwriting income. This can occur, for instance, if the ceding company is a Phase I company. (A Phase I company is one that pays policyholder dividends in excess of the deductible amount so that its tax base essentially is taxable investment income.)

In the case of modified coinsurance, investment income derived from the assets relating to the reinsured policy is paid by the ceding company to the reinsurer as part of the premium for the reinsurance. Thus, this income is included as premium or underwriting income by the reinsurer. A Phase I ceding company, however, does not receive a deduction for this amount because taxable investment income is not reduced by reinsurance premiums the company pays. Consequently, the investment income derived from the assets relating to the reinsured policy is taxed to the ceding company as taxable investment income and to the reinsurer as underwriting income.

Question 6a. Is the section 820 election the only way double taxation can be avoided under Subchapter L?

Answer. No, while we believe there are other ways to avoid double taxation, it would be necessary to change other provisions of Subchapter L, and these would need to be substantial revisions. We believe that such revisions should only be considered in conjunction with the overall revision of the 1959 Act.

Question 6b. The stopgap proposal, which includes the repeal of section 820, does not address the double taxation problem. Does this mean that the double taxation problem is no longer as great a concern as it was in 1959?

Answer. The stopgap proposal does deal with the double tax problem, though not explicitly. By changing the policyholder dividend deduction so that it is no longer limited by taxable investment income, the stopgap proposal eliminates much of the double tax problem. However, in the interest of dealing simply and reasonably on an interim basis with the major problems of life company taxation, the industry stopgap proposal does not attempt to comprehensively solve all the double tax problems that arguably may arise under MODCO contracts. Any permanent system of life company taxation, however, should prevent double taxation, which remains a serious concern today as it was in 1959.

The stopgap's change in the dividend deduction limitation eliminates much of the double tax problem because most companies with modified coinsurance arrangements will no longer be in a Phase I tax position. Instead, a company that pays dividends in excess of the amount deductible under present law will have gain from operations less than its taxable investment income. The tax base of such a Phase II negative company is its gain from operations, and gain from operations is fully reduced by reinsurance premiums paid. Consequently, the investment income derived from the assets relating to a reinsured policy, which is included in underwriting income by the reinsurer, is fully deducted by the ceding company. Thus, since the dividend deduction levels under the stopgap proposal are not based on taxable investment income, much of the double tax problem arising from MODCO contracts is eliminated.

Question 6c. Does this double taxation problem arise, or is it mitigated to some extent, under MODCO agreements where experience refunds are paid?.

Answer. If the experience refund is large enough to eliminate the profit of the reinsurer, the double taxation is eliminated. To the extent that the experience refund is smaller than this, some double tax may remain.

Question 6d. Do you feel that Treasury's proposed regulation or legislative proposal on MODCO addresses this problem?

Answer. Treasury's legislative proposal does not address the double tax problem. It merely repeals section 820, which deals with this problem, without making any other change to eliminate or mitigate the problem.

Treasury's regulatory proposal does retain section 820 so that it could in some cases eliminate the double tax problem. The regulatory proposal, however, undercuts this by recreating taxable investment income in the hands of the ceding company. In a case in which there is an experience refund and a residual profit on the business in the hands of the reinsurer each equivalent to the taxable investment income, then the same amount of income would be taxed once as taxable investment income to the ceding company and once as gain from operations to the reinsurer.

Question 7. Your proposal to Congress is to provide greater income tax deductions to life insurance companies so as to make permanent life insurance a more attractive investment vehicle for the consumer. This could be accomplished through price reductions taking the form of dividends to policyholders; dividends payable, we assume, because of the deductions allowed to absorb their payment. Is it fair to characterize the nature of such a transaction, when looked at in its entirety, as a form of tax arbitrage—the product is significantly marked up at sale, the company receives the dividend paid deduction and the consumer gets a price reduction in the form of the dividend, with the company investing the spread in the meantime?

Answer. No, it is not fair, nor is it accurate, to characterize the whole participating dividend process as tax arbitrage. The question suggests that the ACLI's stopgap

proposal might encourage the temporary shifting of funds from insurance policyholders to life insurance companies (in the form of "price markups," to be later returned in the form of dividends), in order to profit from a differential between the tax treatment of investment income received by life insurance companies and that of investment income received by policyholders. There are several reasons why this is not correct.

There are not, literally, amounts added to the expected cost of insurance in order to pay dividends. Rather, in participating insurance the expected cost is calculated under quite conservative assumptions about future costs, and dividends become payable as the future turns out better than the assumptions.

It is true, however, that participating insurance premiums are generally higher than nonparticipating premiums when the policies are, in other respects, similar. This higher premium receipt, however, goes into the gross income of the life insurance company. While that money is held by the company and invested, the investment income goes into gross income. Under the stopgap proposal, the combination of the part of premiums which later prove to be higher than needed, and investment earned thereon, are included in the tax base at 100 percent when they come into the life insurance company and are deductible at 80 percent or 87½ percent when they go out as policyholder dividends. The only arbitrage in this is the arbitrage in favor of the government.

Question 8. Would the industry agree with the proposition that it is appropriate for the tax-writing committees to closely examine, and perhaps establish more certain rules for, the tax treatment of life insurance company products?

Answer. Congressional efforts to provide more certainty in taxation have potential benefits for any taxpayer but only if the law is changed in the direction of the right answer.

The industry's interests in establishing greater certainty in the taxation of its companies and their products is tempered, obviously, by a corollary concern that recognition must be given to the unique nature and characteristics of those companies and products. As an industry, we believe that the long-established Congressional policy of recognizing the unique nature of the life insurance companies and their products is based upon a sound and vaild foundation, and has had beneficial results for all. Therefore, within the context of this well-founded policy, the industry would welcome the opportunity to work with your committee to clarify tax issues which may currently exist relative to the taxation of life insurance companies or certain of their products.

Question 8a. Under the present law, investment income credited to annuities and life insurance products may be tax deferred (or, in some cases tax-exempt) for the individual taxpayer, and deductible or excludable from taxable income for the payor-life insurance company. In this respect, are there any other "investment products," to your knowledge, with comparable tax treatment?

Answer. It is important to recognize that life insurance products, although they have investment aspects, are unique in their provision of protection against risk. The reason for not taxing amounts set aside for policyholder reserves has often been explained by the social policy of encouraging the purchase of life insurance to provide for surviving dependents and to prevent them from becoming wards of the state. This is an important public purpose that should be maintained. Even if this policy is disregarded, however, it is clear that there are a number of investment products that are taxed more favorably than the investment aspects of life insurance products are taxed.

Other financial intermediaries receive deductions for amounts paid, but not taxed, to their customers. For instance, a bank or savings and loan fully deducts interest on deposits even if the interest is excluded from the depositor's income under section 116 or 128. Life insurance companies, however, do not receive a full deduction for amounts paid to their customers because the deduction for policyholder dividends is limited. The result is that these nondeductible dividends are taxed at corporate rates.

This partial deduction results in a tax at the company level for which the "investor" doesn't get credit. It should be remembered that on nonqualified life insurance and annuity products, the policy is purchased out of after-tax income, that is, there is no deduction for the premium. Investments in IRAs or Keogh plans or qualified employer plans generate current deductions. Other "investment products" do not generate current deductions for the investment but the investment income they generate is taxed at very low or even zero rates. These types of investments include municipal bonds, investment in an owner-occupied housing, All-Savers certificates, assets with prospective capital gains and interest earned on bank deposits when such interest is subject to the interest exclusion.

Question 8b. Doesn't a larger deduction for policyholder dividends free still a greater portion of the investment income earned by the life insurance company, and derivatively by the policyholder, from current taxation (or taxation altogether) at either the company or individual level? What is the justification for this favorable tax treatment of insurance products as compared to other "investment products"?

Answer. The question associates the tax paid by life insurance companies and the total investment income accruing for the benefit of policyholders. If we assume such association is meaningful, it should be pointed out that a life insurance company as a corporation is taxable at 46 percent, a rate far higher than the rate applicable to almost all policyholders. Thus, the significance of allowing a deduction of part of this investment income is that the combination of the deduction portion and the 46 percent rate determines the effective tax rate on this income which might be compared to the other "investment products." Our estimate is that the revenue under the stopgap looked at this way produces a 12-14 percent tax on nonpension net investment income.

This is a reasonable burden in the light of the total picture of taxation of various "investment products" which we just described. It is particularly noteworthy that a recent study by a Treasury economist concluded that the average marginal individual income tax rate on all investment income, including that which is partly or fully exempt is 10 percent.

Moreover, because of inflation, the real rate of return of policyholder savings through life insurance has been negative recently. Therefore, any tax imposed on these savings causes additional real losses.

Question 8c. In an age of creative product development, can you suggest any guidelines for distinguishing between "valid" insurance products and "investment products"? For example, what is the significant difference between a deferred annuity during the accumulation phase and an investment account or deposit with a mutual fund, money market fund, or bank? Would you compare universal life insurance to a traditional whole life policy, or to term life insurance with a side annuity or accumulation fund?

Answer. New life insurance products have proliferated as companies have attempted to respond to high interest rates and inflation. While there are similarities and differences between the life insurance and annuity products we sell and any number of other investment vehicles sold by the other institutions; it would be incorrect to conclude that because some life insurance products have similarities to other investment vehicles, they are the same as those vehicles and should be precluded from life insurance tax treatment.

The industry is continuing to work to develop guidelines for the taxation of these products and has discussed these matters on a preliminary basis with Congressional and Treasury staff. There is not time, however, to develop the appropriate tax rules for these products this year. Indeed, one of the purposes of the stopgap proposal is to give Congress, Treasury and the industry some breathing space so that these complex matters can be given the extensive study they require.

Mr. GEPHARDT. Mr. Fowler?

Mr. FOWLER. Well, I don't think I will prolong it, except to associate myself with the remarks of the gentleman from New York, Mr. Conable. I do think that I am pleased that the industry has come forward and worked some of these problems out by itself.

I think that the temporary nature is necessary, especially as a backup to the regulations in case we have problems there, and therefore I have joined Mr. Conable and my friend from South Carolina, Mr. Holland, in cosponsoring this measure. I hope that it will lead not only to some solutions but to the thoroughness that the whole study deserves.

I thank you for your testimony.

Mr. FROEHLKE. We join you in that hope.

Mr. FOWLER. Thank you.

Thank you, Mr. Chairman.

Mr. GEPHARDT. Thank you, gentlemen.

We appreciate your coming here today and making your testimony. It will be very helpful to the committee in arriving at the answers in this area.

The committee will continue these hearings on Monday, April 5, 1982, at 10 a.m.

The committee is in recess until that time.

[Whereupon, at 11:45 a.m., the committee adjourned, to reconvene at 10 a.m., Monday, April 5, 1982.]

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